87-51

FILED
JUL 2 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. _____

IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1986

MAGDALINE M. HANSEN, individually and on behalf of all those similarly situated,

Appellants,

v.

THE CITY OF SAN BUENAVENTURA,

Appellee.

ON APPEAL FROM
THE SUPREME COURT OF CALIFORNIA

JURISDICTIONAL STATEMENT

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QUESTIONS PRESENTED

The Ventura Water System is a public utility owned by the city of San Buenaventura (hereinafter "Ventura"), which provides water service to customers within city limits and to customers outside the city as well. Under Ventura's municipal rate-setting ordinances, the nonresident water customers pay 70% more than is paid by in-city water customers of the city for the same water service.

The questions presented are:

1. Is it a denial of equal protection of the laws for out-of-city customer ratepayers of a city-owned water system to be separately classified solely on the basis of their nonresident status, and required to pay a seventy percent (70%) surcharge over and above in-city water rates for the same service, when: (a) There is no

difference in the cost of providing water to the in-city customers as opposed to out-of-city customers of the water system; (b) all repayments of principal and interest on bonds issued to finance the acquisition of the water system and its improvements have been made from water system revenues received from all customers (resident and nonresident), and not from taxes; (c) all operating expenses on the books of the water system are paid from the rate revenues of all customers (resident and nonresident), and not with tax funds.

2. Where the record shows that a city's assertions of the legislative purposes for a rate surcharge were not the actual, articulated purposes for which the city council imposed the 70% surcharge on out-of-city customers, and

where the record shows that the asserted purposes could not have been the goal of the surcharge legislation, should not the courts reject such asserted purposes in equal protection analysis, under the rationale of Weinberger v. Wiesenfeld (1975) 420 U.S. 636, 648, 95 S.Ct. 1225, 1233, n.6.

3. Is it an impermissible legislative purpose and therefore a denial of equal protection for a city-owned utility to earn a profit or return on investment from nonresident customers when those customers have provided the investment? And, assuming arguendo that this is permissible, is it a denial of equal protection for a city to charge a return on investment against out-of-city customers of its water system without charging an identical return against in-city customers.

4. Where city ordinances impose a surcharge on water customers who are nonresidents, where the revenue studies accepted as justifications for the surcharge exclude substantial revenues from out-of-city customers, and where the reasons given for excluding such revenues are unrelated to the reasons given for separately classifying nonresidents, is there a denial of equal protection.

5. When a city-owned utility imposes a 70% surcharge on its nonresident customers, and when the surcharge bears either no relationship of any kind, or no reasonable, real and substantial relationship, to any legitimate purpose, are such nonresident ratepayers deprived of substantive due process.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED.....i

TABLE OF AUTHORITIES.....viii

JURISDICTIONAL STATEMENT.....1

OPINIONS BELOW.....1

JURISDICTION.....2

CONSTITUTIONAL PROVISIONS AND ORDINANCES INVOLVED.....4

I. STATEMENT OF THE CASE.....4

A. Appellants Raised Their Constitutional Claims at Every Level Below.....4

B. Statement of Facts..... 8

(1) Historical Background of the Ventura Water System.... 9

(2) There is No Difference in The Cost of Providing Water to In-city as Opposed to Out-of-city Customers of the Ventura Water System.....19

(3) The Ventura Water System is Operated as an Enterprise Fund.....20

(4) Capital Improvements of the Water System are Financed on a Self-supporting Basis.....22

(5) Nonresident Customers and Resident Customers Were Brought into the Ventura Water System Under the Same Circumstances: By Ventura's Purchase of Private Water Companies.....23

II. THE QUESTIONS ARE SUBSTANTIAL....24

ARGUMENT

1. SURCHARGED NONRESIDENT CUSTOMERS ARE DENIED EQUAL PROTECTION, INASMUCH AS THEY ARE SIMILARLY SITUATED TO RESIDENT CUSTOMERS, AND THERE IS NO RATIONAL BASIS FOR SEPARATELY CLASSIFYING AND SURCHARGING THEM 70%..... 24

(a) Strict Scrutiny (Suspect Class).....26

(b) Traditional Equal Protection Test.....31

(1) The Class of Resident Customers and the Class of Nonresident Customers are Similarly Situated as to Cost of Service, Financing of the System, Burdens on the System, Non-Rate Revenue Sources, and as Beneficiaries of Public Trust Assumed by Ventura.....32

(2) City Property Tax Liens Which are Decreasing and Have Never Been Called on Provide no Rational Basis for the Imposition of a 70% Surcharge on Nonresident Customers, Nor do Reconstructed Indirect Administrative Expenses.....38

2. PROFIT OR RETURN ON INVESTMENT WAS NOT THE ACTUAL, ARTICULATED PURPOSE OF THE SURCHARGE ORDINANCES, AND SHOULD THEREFORE BE REJECTED AS A JUSTIFICATION FOR THE SURCHARGE.....42

3. PROFIT EXTRACTED FROM OUT-OF-CITY CUSTOMERS IS A DENIAL OF EQUAL PROTECTION.....47

4. THE ARBITRARY EXCLUSION OF OUT-OF-CITY OIL COMPANY REVENUES FROM THE CITY'S REVENUE STUDIES VIOLATES MINIMAL EQUAL PROTECTION STANDARDS.....53

5. THE 70% SURCHARGE DEPRIVES OUT-OF-CITY CUSTOMERS OF SUBSTANTIVE DUE PROCESS OF LAW.....60

III. THE FEDERAL QUESTIONS ARE IMPORTANT AND SHOULD BE DECIDED BY THIS COURT.....60

[Appendix in separate volume]

TABLE OF AUTHORITIES

Cases:	Page:
Brown v. Merlo (1973) 8 Cal.3d 855	43, 56
City and County of San Francisco (1971) 6 Cal.3d 119	49
City of South Pasadena v. Pasadena Land and Water Company (1908) 152 Cal. 579	37
County of Inyo v. P.U.C. (1980) 27 Cal.3d 154	52
Durant v. City of Beverly Hills . .	37
Gray v. Whitmore (1971) 17 Cal.App.3d 1	60
Hobson v. Hansen (D.D.C. 1967) 269 F.Supp. 401	27, 28
In re King (1970) 3 Cal.3d 226 .	26, 31
Metropolitan Life Insurance Co. v. Ward (1985) 105 S.Ct. 1676	48, 51
Nyquist v. Mauclett (1977) 432 U.S. 1	29
Pacific Tel. & Tel. Co. v.P.U.C. (1965) 62 Cal.2d 634	50
Purdy & Fitzpatrick (1969) 71 Cal.2d 566	26, 27, 29
Reed v. Reed (1971) 404 U.S. 71	.31, 32, 56

Royster Guano Company v. Virginia (1920) 253 U.S. 412 . . . . . 31, 32

San Antonio School District v. Rodriguez (1973) 411 U.S. 1 . . . . . 26, 27

Schlesinger v. Ballard (1975) 419 U.S. 498 62

Shapiro v. Thompson (1969) 394 U.S. 618 . . . . . 26, 64

Southern California Gas Co. v. P.U.C. (1979) 23 Cal.3d 470 49

Weinberger v. Weisenfeld (1975) 420 U.S. 636 43

Women's Liberation Union v. Israel (D.R.I. 1974) 379 F.Supp. 44 . . . 43

Zobel v. Williams (1982) 102 S.Ct.Rptr. 2309 64

Constitutional Provisions:

Fourteenth Amendment, United States Constitution 4

State Statutes:

Government Code section 54514 . . 50, 51

Treatises and Miscellaneous:

California Constitution Revision Commission, Background Study relating to Article XI: Local Government 62

Developments in the Law, Equal Protection (1969) 82 Harvard L.R. 1065, 1125 27

Municipal Service and Equal Protection (1969) 20 Hastings L.J. 1367 . . 28

JURISDICTIONAL STATEMENT

Magdaline M. Hansen, individually and on behalf of all those similarly situated, appeals from the final judgment of the Supreme Court of California, filed December 31, 1986, holding that municipal ordinances which impose a seventy (70) percent surcharge only on nonresident customers of the water system of the City of San Buenaventura are valid.

OPINIONS BELOW

The opinion of the California Supreme Court is reported at 42 Cal.3d 1172, 233 Cal.Rptr. 22, and is reproduced in the Appendix separately presented[1] at pages 1-73. The Opinion, and the Opinion on Denial of Rehearing and Modification of Opinion of the Court

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[1]Rule 15.1 of the Rules of the Supreme Court permits an appendix to be separately presented if the required contents are voluminous.

of Appeal of California, Second Appellate District, Division Six, are unreported, and are reproduced in the Appendix at pages 75-221 and 222-230, respectively. The Findings of Fact and Conclusions of Law and the Judgment of the Ventura County Superior Court of the State of California are unreported, and are reproduced in the Appendix at pages 231-333 and 334-336.

JURISDICTION

The decision of the California Supreme Court, holding that municipal ordinances imposing a 70% surcharge on nonresident customers of the Ventura Water System are valid, was filed on December 31, 1986. Appellants timely filed a petition for rehearing. The Court extended the time for granting or denying rehearing to February 27, 1987, and on February 5, 1987, denied appellants' petition for rehearing, at

which time the judgment became final. A copy of the Order of the California Supreme Court denying appellants' petition for rehearing is reproduced in the Appendix at page 74. Notice of Appeal to this Court was timely filed with the California Supreme Court on March 23, 1987. A copy of the Notice of Appeal is reproduced in the Appendix at pages 337-338. On April 23, 1987, within 90 days from the denial of rehearing below, appellants filed an application for a 60-day extension of time within which to docket their appeal in this Court, said extension to and including July 5, 1987. On April 24, 1987, the application was granted. This appeal is being docketed in this Court within the extension granted. The jurisdiction of this Court is invoked

under 28 U.S.C. section 1257(2).[2]

CONSTITUTIONAL PROVISIONS AND ORDINANCES INVOLVED

Fourteenth Amendment, United States Constitution: "No State shall. . . deny to any person within its jurisdiction the equal protection of the laws."

Ordinances of the City Council of the City of San Buenaventura:[3]

Ordinance No. 1727;

Ordinance No. 75-29;

Ordinance No. 77-27.

I. STATEMENT OF THE CASE

A. Appellants Raised Their Constitutional Claims at Every Level Below.

The instant case is a class action that was brought on behalf of over 3,000 plaintiffs who are out-of-city customers

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[2]City ordinances are state statutes within the meaning of 28 U.S.C. Section 1257(2). King Manufacturing Company v. City Council of Augusta et al (1928) 277 U.S. 100, 102-114.

[3]The pertinent text of these ordinances is set forth in the Appendix at pages 339-344.

of the Ventura Water System. At every step of the way in the lower courts, appellants pressed their constitutional claims.

The complaint was filed on June 8, 1973, seeking declaratory relief concerning the validity of the water rates charged to plaintiffs, and damages for the amounts paid pursuant to the surcharge. (CT 1)[4] The allegations of the complaint included the following: "Defendant's ordinance, as it applies to plaintiffs, is therefore violative of the due process and equal protection clauses of the Constitution of the United States ..." (CT 2) In their opening brief at trial, appellants argued that since they were in essentially the same position as the in-

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[4]It was agreed that plaintiffs would make no claim of invalidity or damages based on water rates in effect prior to July 1, 1972. (RT 3)

city customers with regard to cost of service and financing of the system, that the equal protection clauses of the California and United States Constitutions require that they be treated alike. (CT 264, 250-265.) Appellants also asserted in this brief that the 70% surcharge deprives them of substantive due process. (CT 265-267). The trial court rejected plaintiffs' constitutional claims.
(CT 472.)

Appellants raised the same constitutional (and common law) issues in their appellate briefs. The appellate court expressly refused to rule on the constitutional claims: "We conclude that the answer...is found in venerable common law rules and, accordingly, decline to consider the consitutional arguments advanced by the parties." (Appendix p. 77.) In a unanimous

decision, the appellate court reversed the trial court, holding that "a miscarriage of justice occurred requiring us to reverse judgment...", concluding "that in the case before us, reason was replaced by several fictions." (Slip Opinion, page 71 & 72, Appendix p.175)[5]

Appellants pressed these constitutional claims again, this time in their briefs before the California Supreme Court, where 19 cities filed a brief amici curiae against appellants and in support of the position of Ventura. The majority opinion

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[5]Appellants won on every major issue raised in the appellate court. But, instead of declaring the surcharge invalid, the appellate court inexplicably remanded the case for an entire new trial along with its reversal. The City appealed to the California Supreme Court, as did appellants, appellants hoping to avoid a retrial that in practical terms would have spelled defeat in terms of time and expense.

expressly rejected appellants' constitutional claims. It held that the "rational-basis test" applied and could be satisfied "if any state of facts reasonably may be conceived to justify it", and that Ventura met this standard (Appendix p.49), holding that a municipally-owned utility is entitled to a rate of return on its investment from out-of-city customers (Appendix p.2-3). A Concurring and Dissenting Opinion disagreed, concluding that:

"Discrimination in rates can be justified on the basis of differentials in cost in delivering water or on the basis of city contributions but not on the basis of fictitious capital contributions." (Concurring and Dissenting Opinion, Appendix p.73.)

And so appellants press their constitutional claims once more.

B. Statement of Facts.

The facts of the case are undisputed.[6]

(1) Historical Background of the Ventura Water System.

Prior to 1923, the City of Ventura and surrounding out-of-city area was served by the Southern California Edison Company. In 1923, the City purchased the water system of Southern California Edison Company, including its water rights, and commenced to provide water to in-city and out-of-city customers. (EX 51-53) The purchase was financed by general obligation bonds which were issued for the purchase of the water

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[6]When facts are not in dispute, conclusions to be drawn from such facts are questions of law for a reviewing court. Oakland Unified School District v. Olicker (1972) 25 Cal.App.3d 198, 1106-07, 102 Cal.Rptr. 421, 427; Matossian v. Fahmie (1980) 101 Cal.App.3d 128, 135, 161 Cal.Rptr. 532, 535. A reviewing court is not bound by findings or conclusions of the trial court based on undisputed facts. Hartford Accident and Indemnity Company v. All American Nut Company (1963) 220 Cal.App.2d 545, 34 Cal.Rptr. 23, 33.

system and for additions and improvements. All principal and interest were entirely paid from Ventura Water System revenues received from both in-city and out-of-city customers. No sum was ever repaid with funds derived from city real property taxpayers. (E.g., EXs 30 & 31) In 1966, the City purchased the Mound Water Company, including all of its water rights. The purchase of Mound Water Company was also made from Ventura Water System revenues, and not from City real property tax revenues. (EX 16)

In 1969, the City purchased the Saticoy Water Company, including all of its water rights, for approximately $2,000,000. As a result, the Ventura Water System became the only major purveyor of water within the city's service area. The purchase of Saticoy was financed through the issuance of

$2,500,000 of revenue bonds pursuant to the California Revenue Bond Law of 1941. All principal and interest on those bonds have been repaid entirely from Ventura Water System revenues received from both in-city and out-of-city customers; no sum whatsoever has been repaid from City real property tax revenues.[7]

While the majority of the approximately 3,000 plaintiff-appellants became customers of the Ventura Water System as a result of the Mound and Saticoy purchases, approximately 2,500 (or 60 percent) of Saticoy Water Company's customers were within City limits. They also became customers of the Ventura Water System as a result of this purchase. (EX 12)

Out-of-city customers of the Ventura

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[7]The purchase of the Saticoy Water Company by the City was in lieu of condemnation proceedings. (EX 55.)

Water System have been required to pay a surcharge over and above what in-city customers have paid for the same service since March 1, 1935.[8]

The events leading up to the increase in the surcharge imposed on out-of-city customers from 32 percent to 70 percent in 1972 were as follows:

In the spring of 1970, the consulting firm of Wilsey and Ham was retained by the City to analyze the water rate differential between customers inside the City limits and those outside the City limits who were served by the Ventura Water System, to

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[8]Commencing in 1935, through 1952, the average surcharge was 48%; from 1952 until 1972, the average surcharge was approximately 31 to 32 percent; commencing July 1, 1972, and through the present time, the surcharge imposed upon out-of-city customers has been 70 percent over and above what in-city customers pay for the same service. From July 1, 1972, up to the date of trial, the 70 percent surcharge has generated revenues of approximately 1.8 million dollars. (EXs 36 & 37; EXs 6 & 7)

determine what an appropriate and proper differential should be. After analyzing data supplied by City personnel, Harold Heidrick of Wilsey and Ham sent a letter to Mr. Paul Owen, then Director of Public Works[9] of the City, which contained the following:

> "Enclosed are the preliminary results of the inside-outside rate differential study. As you can see, the results are far from the way we all had anticipated. They do justify the existing surcharge on the outside customers, but any additional surcharge would be hard to justify on the basis of available data...
> It is our opinion that the preliminary results indicate it would be difficult to justify a much larger surcharge and that no more time and effort be spent towards that end. (RT 621-621B)

The preliminary study attached to the above-described letter showed that even after charging out-of-city customers for so-called estimated subsidies to out-

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[9]The Ventura Water System is one of four divisions of the Department of Public Works.

of-city residents consisting of use of parks, swimming pool, Fiesta de la Marina, Poinsettia Festival, indirect administrative costs, and foregone interest, a surcharge of only 6.8 percent in addition to the then existing 32 percent figure would be justified.

Approximately six weeks later, on December 31, 1970, Mr. Heidrick again wrote to Paul Owen concerning the same subject:

> "So that there will be no confusion, we have stopped work on the study and recommend that no additional work be undertaken on the inside-outside rate differential study at this time. You will observe that the additional charge required to compensate your City for costs incurred for service outside the City limits is only 6.8 percent. Under the circumstances, we do not feel justified in expending additional funds in an effort to justify a higher differential."

But less than a week later, as reported in a memorandum to his file on January 11, 1971, Mr. Owen gave Mr. Heidrick "a key to the water rate study

during a phone call a week or so previously when he indicated that the oil company operating expenses and revenues would be considered separately by his department." Having given the "key" by Mr. Owen, a few days later, on January 15, 1971, Mr. Heidrick produced the Wilsey and Ham report which concluded that a surcharge of at least 70 percent would be justified.

On April 17, 1972, the Water Problems Committee of the City Council presented a report to the entire Council on its water rate study. It was recommended that the City Council consider adjusting the "outside water rates to a level of a 70 percent differential between inside and outside rates, as justified in the recent Wilsey and Ham study." (Emphasis added.) A public hearing was set for May 8, 1972. At the City Council meeting of May 8,

1972, the Chairman of the Water Problems Committee recommended the increase to a 70 percent surcharge "as justified in a recent Wilsey and Ham water rates study." (Emphasis added.) At the hearing, the City's General Services Director explained that "the 70% differential figure had been arrived at by Wilsey and Ham as that amount which was needed to provide water for county residents, based on water improvements expenditures on outside facilities." (EX 40, emphasis added.)

When the Council was questioned by County Supervisor Franklin B. Jewett as to whether it was its intention to "make money on a vital public service, ... and to generate revenues", City Manager McCombs replied stating "that it was not a question of generating revenues, rather than increasing the tax rate, but is a method of directly eliminating

subsidy of outside water users, ..." He added that the increase "would not make money ..." (EX 40) The ordinance was passed increasing the surcharge to 70 percent effective July 1, 1972.[10]

During the fiscal year 1974-75, the City hired the firm of Brown and Caldwell to perform a new water rates study. The study was performed under the direction of William K. Ferry of that firm. The large Ventura Water System revenues from out-of-city oil companies were <u>included</u> in the study and in Mr. Ferry's computation of Water System revenue requirements. (RT 939-940) One of the subjects to be considered was the surcharge to be imposed upon out-of-city customers. According to a memorandum of March 31, 1975 of a meeting between City personnel

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[10]Because of the length of footnote 9, it appears at the end of this Jurisdictional Statement.

and Mr. Ferry's staff, it would be difficult to justify outside rates 20 percent to 30 percent higher than inside based on cost of service. In spite of this, it was concluded that the 70 percent figure would be used "to support the present lawsuit." (EX 69.) The 1974-75 Brown and Caldwell study, in its final form, simply adopted the existing 70 percent surcharge on out-of-city customers. On August 11, and 18, 1975, the recommendations of Brown and Caldwell were adopted and higher water rates were put into effect by the City Council. The existing 70 percent surcharge on out-of-city customers was continued without any discussion.

In 1977, the City Council again changed its water structure and again imposed a 70 percent surcharge on out-of-city customers. The record is again totally silent concerning the Council's

legislative purpose in continuing the surcharge.

(2) There is No Difference in the Cost of Providing Water to In-City as Opposed to Out-of-City Customers of the Ventura Water System.

With one minor exception, the vast majority of plaintiff-appellants are located in "county islands" which are completely surrounded by City territory, or are in areas contiguous to the City and indistinguishable from the City. Appellants receive their water from the same sources, with the same treatment, through the same pipes, lines, and mains as in-city customers. There is no cost difference whatsoever between supplying water to out-of-city customers as opposed to supplying water to in-city customers. (RT 86-90; EXs 1 & 34.) When an out-of-city area annexes to the City, the 70 percent surcharge is removed and the residents of the newly annexed area pay the lower water rates

applicable to all in-city customers. Nothing else changes. The City admits that its water rate structure is not based upon differences in costs between serving one group of users as opposed to another, rate setting based on such a method being prohibitively expensive. (EX 8)

(3) The Ventura Water System is Operated as an Enterprise Fund.

Funds derived from City real property taxpayers are not, and never have been, used to pay Ventura Water System expenditures. (E.g., RT 432-437) This fact is supported by every document ever published by the City concerning the water system, including annual financial reports, annual budgets, and official bond statements. Without exception, these documents indicate that the Ventura Water System is, and has been, a self-supporting "enterprise

fund." (RT 210-211; EX 16)[11]

State Water Project contract obligations have also been paid solely water system revenues, never with city real property taxes. (RT 1130-31)

Damages caused by disasters or other calamities have been paid for from water system revenues, bond issues repaid from water system revenues, or State Emergency Flood Relief funds, not city real property taxes. (EX 15.) (But in 1946, $118,000 from the water fund was transferred to the sanitation fund to revamp sewage disposal facilities, and was never repaid!)[12]

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[11]Although there has been an occasional loan made from City general funds, such loans have either been completely repaid or are in the process of being repaid with interest. (RT 470-479) But in 1946, the Water System transferred $118,000 to the sanitation fund which was never repaid. (RT 1010 & EX 63.)

[12]Because it is operated as a separate, self-supporting enterprise fund, funds are transferred every year

(4) Capital Improvements of the Water System are Financed on a Self-Supporting Basis.

All capital improvements for the Ventura Water System have been financed on a self-supporting basis, and without funds from the City real property taxpayers. (EX 15)

One source of funds for capital improvements has been the issuance of general obligation bonds. Commencing in 1969, with the bonds issued for the purchase of the Saticoy Water Company, the City has only issued revenue bonds for the Water System. Revenue bond principal and interest are payable only from revenues of the Water System; there is no recourse to the taxing power of

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from the Ventura Water System to the general funds of the City to reimburse the City for services performed by non-Water Department personnel consisting of accounting and billing services. From 1974 on, $150,000 was transferred annually for these services, and lesser amounts were transferred in previous years. (EX 43)

the City for such payments. With regard to all such general obligation bonds and all such revenue bonds, principal and interest repayments have been made entirely from Ventura Water System revenues received from both in-city and out-of-city customers; not one penny has ever been paid by Ventura City real property taxpayers. (RT 212-213; EX 15.)

Non-bond water system improvements are also financed from water system related sources. The principal sources of revenue are acreage fees from developers, depreciation accruals from the water operating budget, and prior year revenue, none of which are contributions or subsidies from City general funds.

(5) Nonresident Customers and Resident Customers Were Brought into the Ventura Water System Under the Same Circumstances: By Ventura's Purchase of Private Water Companies.

Ventura became a water purveyor for residents and nonresidents when it first

assumed the role of water purveyor by purchasing the Southern California Edison Company in 1923 (EX 52.)[13] And in 1969, when the city made its last such purchase (of the Saticoy Water Company), a block of customers was thereby brought into the system of which 60% were residents of the city and 40% nonresidents. In short, nonresidents and residents were swept into the system by Ventura's initiative and acts.

II. THE QUESTIONS ARE SUBSTANTIAL

ARGUMENT

1. SURCHARGED NONRESIDENT CUSTOMERS ARE DENIED EQUAL PROTECTION, INASMUCH AS THEY ARE SIMILARLY SITUATED TO RESIDENT CUSTOMERS, AND THERE IS NO RATIONAL BASIS FOR SEPARATELY CLASSIFYING AND SURCHARGING THEM 70%.

In effect, the 70 percent surcharge creates a classification of: (1) customers who pay normal water rates,

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[13]In 1942, there were 974 out-of-city Ventura Water System service connections (EX R, App. B, Table 1), almost a third of the nonresident class of customer-appellants.

and (2) customers who pay a 70% surcharge in addition to the normal rates for the same service solely as a result of their location outside city limits. A new customer of the Ventura Water System who moves into the city is immediately given the benefit of the lower in-city rate; while a nonresident customer of many years standing, who had for years contributed to the financing of the Water System through revenues paid to the system, would pay 70% more for the same service. In the absence of any difference in the cost of providing service or in financing the Water System, as to these classes, a denial of equal protection has occurred by singling out the nonresident customers and imposing a surcharge on them which generates additional revenues of approximately $300,000 a year.

Under the two-tiered test of equal

protection analysis, a determination must first be made as to which standard of equal protection analysis is to be applied.

(a) Strict Scrutiny (Suspect Class).

The "strict scrutiny" standard is applied where a legislative classification involves a "suspect class" or penalizes the exercise of a fundamental right. Under "strict scrutiny", the governmental entity bears the burden of proving: (1) that there is a compelling state interest which justifies the law in question, and (2) that the challenged classification is necessary to promote that compelling state interest. (E.g., San Antonio School District v. Rodriguez (1973) 411 U.S. 1; Shapiro v. Thompson (1969) 394 U.S. 618; Purdy & Fitzpatrick(1969) 71 Cal.2d 566, 79 Cal.Rptr. 77; In re King (1970) 3 Cal.3d 226, 232, 90 Cal.Rptr.

15, 19.)

The strict scrutiny test should be applied in this case because the class of out-of-city water customers upon whom the 70 percent surcharge is imposed fits the criteria of a "suspect class".

The rationale behind the application of the "suspect class" doctrine is the political powerlessness of such groups.[14] San Antonio Independent School District v. Rodriguez, supra, at p.18; Purdy & Fitzpatrick v. California (1969) 71 Cal.2d 566, 580, 79 Cal.Rptr. 77, 86; Hobson v. Hansen (D.D.C. 1967) 269 F.Supp. 401, 507; see generally, Developments in the Law, Equal Protection (1969) 82 Harvard L.R. 1065, 1125; Municipal Service and Equal

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[14]Classifications based upon racial or ethnic distinctions of any sort are always considered to be "suspect" calling for the application of the strict scrutiny test (University of California v. Bakke (1978) 438 U.S. 265, 290=291, 98 Sup.Ct. 2733, 2748),

Protection (1969) 20 Hastings L.J. 1367, 1378-82. Strict scrutiny has been required for classifications which adversely affect politically powerless groups, as opposed to the normal deference the courts give to legislative and administrative judgments, for the following reasons:

> Judicial deference to these judgments is predicated in the confidence courts have that they are just resolutions of conflicting interests. This confidence is often misplaced when the vital interests of the poor and of racial minorities are involved. For these groups are not always assured of a full and fair hearing through the ordinary political processes, not so much because of the chance of outright bias, but because of the abiding danger that the power structure--a term which need carry no disparaging or abusive overtones--may incline to pay little heed to even the deserving interests of a politically voiceless and invisible minority. These considerations impel a closer judicial surveillance and review of administrative judgments adversely affecting racial minorities, and the poor, than would otherwise be necessary. Hobson v. Hansen (D.D.C. 1967) 269 F.Supp. 401, 507-8. (Emphasis added.)

The strict scrutiny test is applied to classifications which discriminate against aliens, for example, because they are denied the right to vote and thereby "lack the most basic means of defending themselves in the political processes." Purdy & Fitzpatrick v. California, supra; see also Nyquist v. Mauclett (1977) 432 U.S. 1, 97 S.Ct. 2120.

The Ventura Water System is not subject to regulation by the California Public Utilities Commission; it is totally self-regulating with regard to its water rate structure. Water rates are, and always have been, set by the City Council of defendant City. Water customers located inside City limits have the right to vote, and therefore have some measure of political control over the City Council in its role as rate setting body for the Ventura Water

System. But out-of-city customers have no right to vote for or against Council members, nor to run for office on the City Council, nor to vote for or against bonds issued to finance Ventura Water System capital improvements, and have no PUC protection as to rates imposed on them for this vital service. Since appellants are totally politically powerless with regard to the City regarding this vital service, the rationale of the "suspect class" doctrine militates toward application of that doctrine in this case. Therefore, the strict scrutiny test should be applied which shifts the burden of proof to the City to show that there is a "compelling state interest" which justifies the classification, and that it is not merely rationally based but is "necessary to promote that compelling state interest."

(b) Traditional Equal Protection Test.

But even if this standard is rejected here, the classification between in-city customer ratepayers and out-of-city customer ratepayers created by the 70% surcharge fails the traditional "rational relationship test" of equal protection analysis. That test requires that a legislative classification be rationally related to a legitimate state purpose (In re King (1970) 3 Cal.3d 226, 90 Cal.Rptr. 15, 19). All persons similarly situated with regard to the legitimate purpose of the legislation must be treated alike. Reed v. Reed (1971) 404 U.S. 71, 75-76; Royster Guano Company v. Virginia (1920) 253 U.S. 412, 415. States do not have

> "In applying [the Equal Protection Clause,] this court has consistently recognized that the Fourteenth Amendment does not deny to States the power to treat different classes of persons in different ways. [Citations.] The Equal Protection Clause of that Amendment does,

> however, deny to States the power to legislate that different treatment be accorded to persons placed by a statute into different classes on the basis of criteria wholly unrelated to the objective of that statute. A classification must be reasonable, not arbitrary, and must rest upon some ground of difference having a fair and substantial relation to the object of the legislation, so that all persons similarly circumstanced shall be treated alike." Reed v. Reed, supra, quoting with approval Royster Guano Company v. Virginia (1920) 253 U.S. 412, 415.

There is no rational relationship between the resident-nonresident classification and any legitimate legislative purpose. The out-of-city customers and the in-city customers of the Ventura Water System are in essentially similar circumstances with regard to the Water System and should be similarly treated.

(1) The Class of Resident Customers and the Class of Nonresident Customers are Similarly Situated as to Cost of Service, Financing of the System, Burdens on the System, Non-rate revenue Sources, and as Beneficiaries of the Public Trust Assumed by Ventura.

There is no difference in the cost of furnishing water to in-city as opposed to out-of-city ratepayers of the Ventura Water System; there is no difference in the financing of the system between in-city and out-of-city ratepayers; every burden placed on the Water System, such as the need to purchase additional water from more expensive water sources, is a burden placed on it by new in-city customers as well as new out-of-city customers, and benefits such in-city customers as well as out-of-city customers;[15] all non-

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[15]One of the city's experts, Thomas Stetson, attempted to justify the surcharge by arbitrarily allocating the cost of the more expensive water only to the nonresident customers of the system, and arbitrarily allocating the cost of the less expensive water from wells and the Ventura River to the resident customers. The premise behind this was that if the Ventura Water System did not have to replace supplies from the Mound and Saticoy wells, it would have no need to purchase the more expensive water from Casitas. But this ignores the fact that whatever new or additional water

rate revenue sources are from classes that lack identity with the class of resident ratepayers, and benefit either the contributors' property or all ratepayers, and therefore represent no differences between in-city ratepayers and out-of-city ratepayers, the two classes at issue. For example:

The Ventura city council requires that new development pay its way for new facilities necessitated by that development so that it does not become a drain on the existing water system. Developers therefore pay acreage and connection fees as a contribution to those capital assets which benefit the

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supplies were required for nonresidents who were former Mound and Saticoy customers were obviously required as well for residents who were former Mound and Saticoy customers. Indeed, 60% of the Saticoy Customers who were pulled into the system by the city's purchase of Saticoy were residents! The Court of Appeal clearly saw this fallacy and termed the theory "patently ridiculous" for this reason. (Appendix p.147-148.)

particular property being developed. (RT 432; RT 934-935;EXs 66, 67) This provides no basis upon which to surcharge nonresident water service rates.[16]

Power tax revenues are revenues received from the United Water Conservation District (UWCD), a separate governmental entity which overlaps only the eastern portion of the Water System's service area (and which includes residents of Ventura as well as nonresidents, all of whom pay taxes to the UWCD). Thus, the city boundary of Ventura separating all residents from

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[16]The ordinances imposing these fees do not distinguish between in-city and out-of-city developers. But all of this new development has been within the city since the early 1970, (the years pertinent to this litigation,) since it has been the city policy since then not to allow water service without annexation. There has therefore been no new out-of-city development that has failed to pay its way in regard to the Ventura Water System. (RT 906.)

all nonresidents has no relevance to the UWCD boundaries and any revenues received from it.

Finally, it must be borne in mind that the instant case is not a situation where property owners outside city limits approached the city and requested water service where it did not exist before; nor did the city use its own general funds to construct new plant capacity or additional mains, lines of reservoirs for the sole purpose of accommodating such customers. Instead, the out-of-city customers of the Ventura Water System became so involuntarily, as customers of companies which were then purchased by the city for its own purposes under threat of condemnation. (EX 54, 55.) In-city and out-of-city customers of the Ventura Water System are therefore similarly situated in the context of how they came into the

system, too, i.e., as beneficiaries of the public trust assumed by Ventura in its role as a purveyor of water. When a city acquires a private water system, the acquisition is impressed with a trust, and the city will hold title as a mere trustee legally obligated to serve the prior customers of the private system who are beneficiaries of the trust. Only after this obligation is satisfied may the city devote any surplus to the use of its own inhabitants who are outside of the service are of the acquired company. City of South Pasadena v. Pasadena Land and Water Company (1908) 152 Cal. 579, 93 Pac. 290; Durant v. City of Beverly Hills, supra, at 137, 102 P.2d at 761. The City became the only major water purveyor within its service area and, at the same time, assumed the obligation to furnish water to residents and

nonresidents through the acquisition of three private companies: the Southern California Edison Co. in 1923, Mound Water Company in 1966, and Saticoy Water Co. in 1969. Therefore, nonresidents and residents in each of the acquired service areas are similarly situated as beneficiaries of a public trust. As in all trust situations, the trustee must act with total impartiality to the beneficiaries, without favoring its own constituents.

(2) City Property Tax Liens Which are Decreasing and Have Never Been Called On Provide No Rational Basis for the Imposition of a 70% Surcharge on Nonresident Customers, Nor Do Reconstructed Indirect Administrative Expenses.

The issue of City property being subject to liens for general obligation bonds and State Water Project obligations as a claimed justification for the surcharge is a red herring. These deal with contingent liabilities

that have never been called upon, since all principal and interest payments on general obligation bonds and all contract payments on the State Water Project have always been paid out of water revenues of all ratepayers, both in- and out-of-city (RT 212-231; EX 16, 30, RT 1130-31). Thus, to accept this as a basis for the surcharge is in effect assessing non-resident ratepayers for these contingent liabilities before the property taxpayers are so assessed.[17]

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[17]This is particularly irrational and inequitable in light of the fact that property owners voted for the bonds and therefore bound themselves to such a potential liability if the need should arise in the future; the out-of-city ratepayers never voted on such bond issues yet are now liable for this contingent liability before the contingency arises!) Moreover, as general obligation bond contingent liability has decreased over the years, the surcharge has increased. (EX 6) These contingent liabilities are fictions insofar as the history and present situation of the Ventura Water System is concerned, as recognized by

Shortly before trial, to support its position, the City reconstructed the value of time of non-water department city personnel and office space it has incidentally provided over the years without charge to its Water System. Current city personnel estimated the level and extent of services provided for the Water System as far back as 6 and 7 years ago. This reconstruction showed that resident customers of the city-owned Water System indirectly pay very little of this "expense" (which has never appeared on the books of the Water System), while surcharged nonresident customers of the Water System in effect pay more than 10 times their share of such reconstructed salaries and rent. Clearly the proper way to compensate the city for such services and rent is by having the water system reimburse the

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the Dissenting (Appendix p.67-68).

city from the revenues of all customers, just as the Water System reimburses the city for billing and accounting services to the tune of $150,000 each year. It surely provides no basis for distinguishing between resident and nonresident customers by means of a nonresident surcharge that brings in approximately $300,000 per year, when the portion of these indirect administrative expenses attributable to nonresidents amounts to only $26,000 per year. (RT 175, EX R)[18] The dissent clearly recognized this. (Appendix p.68-

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[18]These reconstructed expenses of course never appear on the books of the Ventura Water System, and the general fund never gets reimbursed! Moreover, there is a lack of identity between in-city water ratepayers and the sources of general funds which pay the salaries of non-water department personnel and rental space. General funds come mainly from sales, utility and franchise taxes, licenses and permits, intergovernmental federal, state and county sources, fines and forfeitures, and city charges for current services. (EX 16.)

70).

2. PROFIT OR RETURN ON INVESTMENT WAS NOT THE ACTUAL, ARTICULATED PURPOSE OF THE SURCHARGE ORDINANCES, AND SHOULD THEREFORE BE REJECTED AS A JUSTIFICATION FOR THE SURCHARGE.

The City Council minutes and other legislative materials show that the adoption by the City Council of a 70% surcharge was based entirely upon the recommendations contained in the Wilsey and Ham report of January 15, 1971 (EX 35). Therefore, since the Wilsey and Ham report was the actual basis for the City Council's action in adopting and maintaining the 70% surcharge, the constitutional propriety of that action must be evaluated based on that report, and not on theories created and applied by consultant's years later in an attempt to bolster the city's position at trial. As stated by the United States Supreme Court:

> This court need not in equal protection cases accept at face value assertions of legislative

purposes, when an examination of the legislative scheme and its history demonstrates that the asserted purpose could not have been a goal of the legislation. Weinberger v. Weisenfeld (1975) 420 U.S. 636, 648, 95 S.Ct. 1225, 1233; Women's Liberation Union v. Israel (D.R.I. 1974) 379 F.Supp. 44, 49; Brown v. Merlo (1973) 8 Cal.3d 855, 865 n. 7, 106 Cal.Rptr. 388, 395, n. 7

But the Wilsey and Ham Report was inadequate beyond dispute as a justification for the 70% surcharge. This report justified the 70% surcharge as a reimbursement for so-called "subsidies" made to out-of-city customers by the City and which totalled $172,000 for the test year utilized. (RT 129-20; EX 35.)[19]

The first category of subsidies totalled $32,000 and charged the out-of-city water customers for the use by all out-of-city residents of city parks,

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[19]The Wilsey and Ham analysis did not address the issue of the 32% surcharge which already existed; it merely accepted its permissibility and used its revenues in its computations.

swimming pool, Fiesta de La Marina, Poinsettia Festival, etc. At the trial, Mr. Heidrick, the author of the Wilsey and Ham Report, admitted that such factors are not properly considered.

The major "subsidy" included in the Report was the sum of $135,000 representing "foregone interest on investment in plant servicing the county." Mr. Heidrick's theory was that if the city did not have its investment in that portion of the Ventura Water System attributable to servicing out-of-city customers, it could have used those funds elsewhere, or at least interest could have been earned on those funds. (RT 543-545.) But "foregone interest" is a fiction under the undisputed facts of this case. The city did not take a portion of its general funds, which might have been used elsewhere, in order to construct or purchase additional

improvements to the Water System for the purpose of assisting out-of-city customers. Quite the contrary, capital plant and equipment of the Ventura Water System has come form its own revenues, or from bond issues which have been and are being repaid from its revenues. There was no existing fund, or investment, upon which the city was losing money as a result of its servicing out-of-city customers. (RT 432-434.)

The city, recognizing the infirmities of the Wilsey and Ham Report and recognizing the necessity of coming up with a justification that accounted for most of the surcharge[20], came up

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[20]Under City of Madera v. Black (1919) 181 Cal. 306, 315, 184 Pac. 397, 402, Guy S. Atkinson Co. v. Highland Park Public Utility District (1958) 158 Cal.App.2d 718, 721, 723-724, 323 P.2d 173, 175, 177, Durant v. City of Beverly Hills (1940) 39 Cal.App.2d 133, 139, 102 P.2d 759, 763, and County of Inyo v. PUC (1980) 27 Cal.3d 154, 159, 161 Cal.Rptr.

with the after-conceived justification of the right of the city to extract a profit or return on investment from out-of-city ratepayers, as embodied in the Brown and Caldwell Report's utility method of analysis for nonresidents.

But the record in this case shows that the Brown and Caldwell Report of February 1978, justifying the 70% surcharge as a profit or rate of return, was never put before the City Council. The City Council never authorized the Water System to be operated for profit or return on investment; yet the Court below accepted this as a justification for the surcharge. This Court should reject profit or return on investment as a justification for the surcharge; to do otherwise makes a sham of the public

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172, 175, where a portion of a rate charge is improper, the court may not rule on what the components of the charge should be, but must instead declare the entire charge invalid.

hearings held in April and May of 1972 which resulted in the adoption of the 70% surcharge. To ignore the uncontradicted evidence of the actual legislative purpose and to permit the surcharge to be justified by a report conceived many years later, also has the effect of transferring governmental power from the City Council to an outside consultant. The 70% surcharge should be evaluated by the Court on the basis of its true purpose and legislative objective: the recovery of fictitious subsidies.[21]

3. PROFIT EXTRACTED FROM OUT-OF-CITY CUSTOMERS IS A DENIAL OF EQUAL PROTECTION.

The California Supreme Court did not even consider the Wilsey and Ham Report. It held that a municipal utility is

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[21]The omission of oil company revenues and expenses from the Wilsey and Ham and Brown and Caldwell reports is discussed in section 4, below.

entitled to a reasonable rate of return, thereby validating the surcharge ordinances under the theory espoused in the later-conceived Brown and Caldwell report.[22] But rate of return is impermissible here.

In addition to the requirement of a rational relationship between the statutory classification and the legislative purpose to be served, equal protection requires that such purpose be legitimate or permissible. Metropolitan Life Insurance Co. v. Ward (1985) 105 S.Ct. 1676-1684. It is a basic tenet of public utility law that ratepayers of a utility may not be forced to both provide the investment for a utility and a profit or return on that investment. The majority opinion runs counter to this

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[22]It thereby expressly rejected the rationale of Weinberger, supra, by accepting any conceivable basis for the surcharge. (Appendix p.49)

basic tenet and runs counter to equal protection in validating an impermissible purpose.

Privately owned utilities are owned by investors who have a right to a reasonable rate of return on the value of the property they have devoted to public use. Southern California Gas Co. v. P.U.C. (1979) 23 Cal.3d 470, 476, 153 Cal.Rptr. 10, 13. In such systems, "requiring ratepayers to put up the capital for the [utility] is contrary to the basic principle of utility rate setting." City and County of San Francisco (1971) 6 Cal.3d 119, 129-130, 98 Cal.Rptr. 286, 291. If rates resulted in ratepayers contributing capital to the utility as well as a rate of return, it would " 'provide a source of interest-free capital' " for investors. City and County of San Francisco, supra. Thus, it is clear

that utilities may not both earn a rate of return on capital and at the same time force the ratepayers to contribute to that capital through their rates; this would permit a "double return" to the utility. Pacific Tel. & Tel. Co. v.P.U.C. (1965) 62 Cal.2d 634, 663-664. (Dissent, Appendix p.61-63)

In a city-owned system such as Ventura's, where the city issues bonds to pay for its system which are paid off by the customers, the ratepayers necessarily provide the investment. In conformity with age-old utility law, a profit or return on investment should therefore be barred. And, indeed, so it is under California Government Code sec. 54514 of the Revenue Bond Law[23], the obvious counterpart to the investor-owned utilities proscription against a

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[23]Ventura's revenue bonds have all been issued under this Law.

double recovery. Government Code section 54514 provides as follows:

> Subject to the provisions of Section 54516.1, the local agency shall prescribe, revise and collect such charges that the services, facilities or water of the enterprise are furnished at the lowest possible cost consistent with sound economy, and prudent management, and the security and payment of the principal and interest of the bonds. (Emphasis added.)

This section precludes profit or return on investment, by its express terms; such an objective for the surcharge is therefore impermissible and therefore a denial of equal protection. Metropolitan Life Insurance, supra.

Moreover, even if profit or return on investment was a legitimate, permissible legislative purpose, it is a denial of equal protection for a city to charge such a profit from its nonresident customers without charging the same profit from its resident customers, since both classes are

similarly situated in every context relevant to the Water System. County of Inyo v. P.U.C. (1980) 27 Cal.3d 154, 159 n.4, 161 Cal.Rptr. 172,175 n.4 provides that a showing that "discrimination [in rates] rests solely on the nonresident status of the customer, and not on the cost of service or some other reasonable basis, will prove the rate invalid." Extracting a profit only from nonresidents is the clearest case of a discrimination resting solely on the nonresident status of the customer; profit is by definition not based on cost of service or any other basis of differentiation. It is therefore impermissible.[24]

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[24]The California Supreme Court misstated appellant's assertion of the impermissibility of profit, characterizing it as an assertion that water service must be provided at "cost". Appellants never made this claim. Appellants merely claimed that profit or return in investment was prohibited when the ratepayers provided

4. THE ARBITRARY EXCLUSION OF OUT-OF-CITY OIL COMPANY REVENUES FROM THE CITY'S REVENUE STUDIES VIOLATES MINIMAL EQUAL PROTECTION STANDARDS.

The challenged ordinances create a classification of in-city and out-of-city rates, imposing the surcharge on commercial, industrial and household water consumption. The only water outside of this legislative classification is raw water used for irrigation, which makes no distinction as to residents and nonresidents.

The Wilsey and Ham and Brown and Caldwell revenue studies assumed that one could separately classify in-city customers from out-of-city customers, and then did a revenue requirement study based on this assumption to determine

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the investment. Appellants further asserted that whatever could be validly charged to ratepayers should be charged to all ratepayers. For example, reserves for future expansion would be an item over and above cost, but should certainly be charged to all customers to satisfy equal protection mandates.

the amount of the surcharge. But the study arbitrarily excluded the large industrial out-of-city oil company revenues and expenses. If the huge revenues and expenses of the Shell and Getty out-of-city oil companies had been included in the computations of the city's experts, by their own admission the results reached would be dramatically different (RT 621-622). The Wilsey and Ham report would have computed only a 38.6% surcharge, (most of which was the 32% surcharge which already existed). The Brown and Caldwell report would have computed only a 33.9% surcharge.

The reasons given by the city's experts for excluding these revenues and expenses are related to cost factors, such as the fact that Shell receives totally untreated water and Getty receives partially treated water. But

these contentions are constitutionally infirm, since water treatment is irrelevant to the asserted purposes of the surcharge classification; the supposed justifications for singling out-of-city ratepayers from in-city ratepayers have nothing to do with water treatment. Water treatment is a criterion wholly unrelated to the supposed objective of recovering subsidies or a rate of return from out-of-city customer, and therefore flies in the face of equal protection.

If rates are set by determining revenue requirements for certain classes of customers, then the rationale that determines the classes must be uniformly applied to all those who fit that criterion. Anything less is a denial of equal protection, which requires that "at a minimum, 'persons similarly situated with respect to the legitimate

purpose of the law receive like treatment.' " Brown v. Merlo, supra; Reed v. Reed, supra. If the rationale is based strictly on political boundary, as where it is claimed that indirect "subsidies" are given to out-of-city customers, this rationale applies to all out-of-city customers. The uniform application of this rationale mandated by equal protection requires that revenue requirements for out-of-city customers be determined by utilizing revenues and expenses of all out-of-city customers.

The same is true with regard to the return on investment justification relied on in the Brown and Caldwell report. Even if return on rate base only from out-of-city customers was valid, then it should logically apply to all out-of-city customers, including oil companies.

To simply omit one of the most lucrative portions of sales to out-of-city customers constitutes a flagrant violation of constitutional principles of equal protection which require that legislatively-created classifications, even if created pursuant to acceptable legal criteria, must be complete and must fully include all those persons who logically come within the relevant criteria. Exclusions from the class may not be based on irrelevant criteria.

The city's attempt to ignore these revenues is particularly incredible in light of the fact that the 70% surcharge has been paid by the oil companies for much of the time frame covered by this lawsuit. (RT 265-6, 390-392, EXs 44,45.) If water treatment justifies excluding oil company revenues and expenses from the out-of-city computations used to arrive at the amount of the surcharge,

does it not also justify excluding oil companies from being surcharged?

Amazingly, while Mr. Ferry, the author of the Brown and Caldwell report, testified that he deleted oil company revenues and expenses, he made no deletion whatsoever from the Ventura Water System rate base, and made no deletion whatsoever from normal water system expenses such as administrative expenses, customers accounts, transmission and distribution expenses, property taxes, or depreciation expense. (RT 840-842.) In effect, therefore, all of these other expenses were divided between the in-city and out-of-city potable water users; the oil companies were given a free ride in the computations.

The final irony and inequity can be perceived in the city's attempt to use what it calls unreimbursed services

allegedly performed for the Water System over the years by nonwater department personnel as a rationale for the surcharge. If this were a legitimate rationale, then why does the city use only the revenues of potable out-of-city customers to compute the surcharge? Magically, the oil companies have not been assisted by all of these services. This is another indication of the total irrationality of a classification between in-city and out-of-city customers which attempts to exclude from consideration two out-of-city customers who alone contribute roughly 10% of the annual revenues of the entire Ventura Water System.[25]

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[25]As said by the Court of Appeal: "You do not have to be a PHD in economics from Harvard to understand what happens when you eliminate a source of profit from your books of account." (Appendix p.227) And, as pointed out above, the city's own experts included those revenues and expenses when first hired by the city!

5. THE 70%SURCHARGE DEPRIVES OUT-OF-CITY CUSTOMERS OF THE VENTURA WATER SYSTEM OF SUBSTANTIVE DUE PROCESS OF LAW.

What has come to be known as "substantive due process," pursuant to the Fourteenth Amendment of the United States Constitution, is essentially a protection against arbitrary legislative action. A legislative enactment "must not be unreasonable, arbitrary or capricious but must have a real and substantial relation to the object sought to be attained." Gray v. Whitmore (1971) 17 Cal.App.3d 1, 22, 94 Cal.Rptr. 904, 915. (Emphasis added.) The essence of substantive due process is the basic concept of fair play. Id at 28, 94 Cal.Rptr. at 919.

There is simply no relationship between the $300,000 annually derived from the 70% surcharge and any legitimate purpose.

III. THE FEDERAL QUESTIONS ARE

IMPORTANT AND SHOULD BE DECIDED BY THIS COURT.

The practice of charging nonresidents more than residents of a city-owned utility is a nationwide practice, yet this Court has never passed on its constitutionality. The practice is particularly egregious in California where nonresidents do not even have the protection of a public utilities commission as they do in many other states. In the 1960s, the California Constitution Revision Commission, in analyzing the authority of municipalities to provide utility service to nonresidents, addressed the problem of the potential for abuse as to such politically powerless utility customers, recognizing that:

> "The persons receiving such services, being non-residents, have little or no political power which may be exercised to prevent abusive treatment...[T]he city retains substantially full control over its own utility operations outside its boundaries, without any developed

> legal standards (other than the last-ditch constitutional arguments of Equal Protection and Due Process) as a basis for judicial review of ... practices detrimental to... nonresident utility consumers such as discriminatory rates or charges." California Constitution Revision Commission, Background Study relating to Article XI: Local Government, p.396,(emphasis added).

And, even the "last-ditch" argument of equal protection becomes dangerously attenuated if the legislature is not accountable for its actual, articulated purpose in enacting such class legislation. Most pertinent on this issue is the observation of Justice Brennan in his dissenting opinion in Schlesinger v. Ballard (1975)419 U.S. 498, 520-521, 95 S.Ct. 572, 583-584. Justice Brennan commented on the court's acceptance of a legislative purpose that was not in fact the actual purpose of the enactment at issue:

> Never, to my knowledge, have we endeavored to sustain a statute upon a supposition about the legislature's purpose in enacting it

> when the asserted justification can be shown conclusively not to have underlain the classification in any way.[Footnote 11: Indeed, to do so is to undermine the very premises of deference to legislative determination. . .[this] is not properly deference to a legislative decision at all; it is deference to a decision which the legislature could have made but did not.]"

The importance of this issue is enormous, and is applicable to every state and local legislative body. The California Supreme Court's acceptance of later-conceived theories never put before the city council has the effect of transferring the decision-making process to hired consultants.

The majority opinion below states that a rate of return permits past ratepayers to be credited for their past contributions to capital (Appendix p.37). But as the Dissent points out, past ratepayers versus new ratepayers "is not the basis of the discriminatory rates. (Appendix p.70) The basis is

solely political boundary. The majority opinion rests on the erroneous premise that all new customers are nonresident, and all old customers residents. In fact, residents include new customers while nonresidents include older customers.[26] But even if the majority opinion's premise had been correct, to surcharge nonresidents on this basis is a clear denial of equal protection. This court has consistently held that apportioning benefits or services on the basis of past contributions is prohibited by the Equal Protection Clause. Shapiro v. Thompson (1969) 394 U.S. 618, 632-633; Zobel v. Williams (1982) 102 S.Ct.Rptr. 2309, 2314.

The lack of uniformity in the lower

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[26]The Dissent points out that when Ventura bought Saticoy in 1969, 60% of these new customers were residents; and, prior to the Saticoy acquisition, 1,000 of the service connections (i.e.older customers) were outside city limits. (Appendix 70-71.)

court decisions in the instant case also begs the intervention of this Court. The history of this 15 year old case demonstrates just how difficult it is to depend on the "last-ditch argument of equal protection" in attempting to remove the yoke of discriminatory rates. The attempt finally ends at this high Court. Appellants respectfully request that this Court reverse the California Supreme Court decision, and hold that the ordinances imposing the 70% surcharge on nonresident customers of the Ventura Water System deny them the equal protection of the laws and substantive due process.

July 2,1987

Respectfully submitted,
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_____
HELENE STONE

87-513

No._____

Supreme Court, U.S.
FILED
JUL 2 1987
JOSEPH F. SPANIOL, JR.
CLERK

IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1986

MAGDALINE M. HANSEN, individually and on behalf of all those similarly situated,

Appellants,

v.

THE CITY OF SAN BUENAVENTURA,

Appellee.

ON APPEAL FROM
THE SUPREME COURT OF CALIFORNIA

APPENDIX TO JURISDICTIONAL STATEMENT

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APPENDIX

Appendix Page:

Opinion, California Supreme Court, Filed Dec. 31, 1986..... 1-51
Concurring and Dissenting Opinion.....52-73

Order Denying Rehearing, California Supreme Court, Filed Feb. 5, 1987.....74

Opinion Filed April 8, 1985 Court of Appeal of California, 2d Appellate District, Division 6.....75-178
Appendix to Opinion.....179-221

Opinion on Denial of Rehearing and Modification of Opinion Filed May 7, 1985, Court of Appeal of California, 2d Appellate District, Division 6.....222-230

Findings of Fact and Conclusions of Law, Ventura County Superior Court, Filed Aug. 17, 1981.....231-333

Judgment of Ventura County Superior Court, Filed Aug. 17, 1981.....334-336

(see next page)

Notice of Appeal to the
United States Supreme Court,
Filed March 23, 1987..... 337-338

Ordinances of the City of
San Buenaventura:
No. 1727..... 339-340
No. 75-29.....341-343
No. 77-27.....343-344

SUPREME COURT
FILED
DEC. 31, 1986
Laurence P. Gill, Clerk

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

L.A. 32091
2 Civ.67886
(Super.Ct. No. 55769)

MAGDALINE M. HANSEN et al.,
Plaintiffs and Respondents,

v. [OPINION]

CITY OF SAN BUENAVENTURA,
Defendant and Appellant.

Defendant City of San Buenaventura (hereafter referred to as Ventura) owns and operates a water company which serves customers who reside both in and outside the city boundaries. In 1972, Ventura enacted an ordinance imposing a 70 percent surcharge on water supplied to customers living outside the city limits. Those nonresident customers brought this class

action to challenge the surcharge, seeking declaratory relief and damages on the ground that the rates imposed were unreasonable, arbitrary, and discriminatory and that the rate structure denied them equal protection. Following a nine-day trial, the superior court held the 70 percent surcharge was reasonable and entered judgment for Ventura. The Court of Appeal reversed and remanded for a new trial; Ventura sought review in this court.

SEE CONCURRING & DISSENTING OPINION

We granted review to resolve the important question of whether a municipal utility may recover a reasonable rate of return on its investments and to clarify what circumstances may be considered by a court in determining whether a rate is reasonable. We conclude that a

municipal utility is entitled to a reasonable rate of return and, for reasons we shall explain, we agree with the trial court that the 70 percent surcharge on water supplied nonresidents in this case was justified. Accordingly, we reverse the judgment of the Court of Appeal.

I

The city of Ventura has owned and operated its own municipal water system since 1923 when it bought the facilities of the public utility corporation that had previously supplied water to the city and surrounding areas. Ventura financed the sale through a $250,000 general obligation bond issue. Between 1925 and 1960, the citizens of Ventura authorized four additional general bond issues to improve and modernize the system. Totalling over $3.6 million, these bond issues subjected all private

property in the city to a lien: if funds were unavailable to pay the bonds, the bondholders had the right to require Ventura to levy taxes on all private property to meet the bond indebtedness.

Throughout the years, the citizens of Ventura demonstrated their commitment to the system by allowing the city to use its general fund monies to help maintain and improve the system. Ventura used its general fund monies 1) to provide office space for water system employees as well as for city employees who rendered services for the water system and 2) to pay a portion of the salaries of city employees who performed accounting, billing, administrative, and legal services for the water system. Additionally, Ventura made a number of transfers from its general fund to the water system at little or no interest.

Ventura also used power taxes in the

amount of nearly $300,000 to support the water system in the 1971-1972 and 1976-1977 fiscal years. These funds represented transfers to the system from tax payments made by residents only. Additionally, Ventura required new in-city customers to pay upfront connection and acreage fees to obtain water service. These contributions, which were used to benefit the entire water system, totalled over $600,000 from 1964 until trial, in 1978. No water system revenues have ever gone to Ventura's general fund; all water revenues, acreage and connection fees, power tax revenues, and contributions from the city's general fund have been used to operate and maintain Ventura's water system.

In 1966, Ventura purchased the Mound Water Company (Mound), a small

mutual water company[1] serving customers outside the city. At the time of the sale, Mound represented to Ventura that the Mound shareholders, that is the Mound customers, had approved the transaction. Thus, the sale was truly consensual in that the very customers who were to receive water from Ventura ratified the purchase.

Pursuant to the terms of the purchase agreement, Ventura agreed to furnish water "to those customers heretofore served by Mound who may desire such service at the regularly established rates for water service from the Ventura Water System." However, nothing in the sale agreement precluded

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[1]Public Utilities Code section 2725 defines a mutual water company as "any private corporation or association organized for the purposes of delivering water to its stockholders and members at cost, including use of works for conserving, treating and reclaiming water."

Ventura from continuing to apply reasonable rate differentials between residents and nonresidents as it had done for years.[2] The purchase agreement only assured that Ventura would continue to provide service at regularly established rates to customers served by Mound at the time of the sale.

The water that Mound had supplied its users prior to the sale came from wells of poor quality which were below public health standards. On acquisition, Ventura abandoned the polluted wells and commenced supplying the former Mound customers with water of

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[2]Ventura has maintained a differential in water rate schedules for over 50 years, with out-of-city customers required to pay higher rates than in-city customers. Between 1935-1952 the average surcharge was 48 percent, while between 1953 and 1972 that figure dropped to 32 percent. Pursuant to the ordinance enacted in July 1972 and continuing until the present, the surcharge imposed on out-of-city customers has been 70 percent.

substantially better quality. It is undisputed that the sale of Mound to Ventura immediately and significantly improved the quality, availability, and overall source of supply and service to the customers previously served by Mound, customers who all live outside the city boundaries and are presently subject to the disputed surcharge.

In 1969, Ventura acquired a second water company, the Saticoy Water Company (Saticoy). Saticoy was an investor-owned public utility, 60 percent of whose customers were residents of Ventura, 40 percent nonresidents. Because of the nature of the ownership of the utility, the Saticoy customers were not given an opportunity to approve the sale. However, they were given the chance to participate in an election to approve or disapprove the purchase of Saticoy by Ventura. Close to 90 percent

of those customers who voted registered approval. In addition, customers also had the opportunity to appear before the Public Utilities Commission (hereafter referred to as P.U.C.), but it appears no protests were in fact received.

Under the terms of the agreement, Ventura was bound for 60 days to maintain the rates charged by Saticoy prior to the sale; however, following the 60-day period, Ventura had the right to alter the preexisting rates. The sale contract further provided: "[Ventura] agrees that from and after the closing date it will serve water without unfair or unreasonable discrimination to all customers in the area wherein [it] is certified to provide service by the California Public Utilities Commission whether such customers are located within or without the territorial boundaries of the city

and will continue to serve all of such customers." Nothing in the sale agreement, however, specifically precluded Ventura from applying reasonable rate differentials between residents and nonresidents.

Saticoy customers benefited immediately and substantially from the sale. Instead of continuing to rely on four small storage tanks, they suddenly had available over fifty million gallons of storage capacity from a vast network of tanks and reservoirs tied into Ventura's system. Further, the two wells formerly owned by Saticoy fell short of state health standards with respect to water quality. Ventura abandoned one well immediately and placed the other on standby status, to be used only in event of emergency.

The improvements to both the former Mound and Saticoy customers were not

without cost. By 1969, Ventura was serving approximately 2,800 out-of-city water users, the vast majority of whom were added in conjunction with the Mound and Saticoy acquisitions. Because Ventura did not have sufficient surplus water of its own and because it did not acquire any surplus water as a result of these acquisitions, Ventura was obliged to purchase additional water. The cost of the additional water purchased from the Casitas Municipal Water District (Casitas) and others was substantially greater than the cost of Ventura-owned water sources.[2] In addition to

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[2]Water purchased in 1970 by Ventura from Casitas cost $44 an acre foot and from Alta Mutual $35 an acre foot. At the time of the 1978 trial date, these prices had jumped to $61 and $56 respectively, vis-a-vis, the $20-$25 price of well water for Ventura. The cost of Ventura river water, obtained by Ventura from its Foster Park facility, is minimal. By virtue of having its own water sources, Ventura saves approximately $30-$40 per acre foot of water that it does not have to purchase.

purchasing additional water to accommodate the needs of its additional customers, Ventura was forced to expand and improve its facilities. Partly because the facilities purchased from Mound and Saticoy were inadequate to meet the needs of customers previously served by these two water companies, Ventura undertook major improvements to improve and expand its own facilities.[3]

In 1970, Ventura acquired by assignment a contract for 10,000 acre feet of water annually from the State Water Project. Under the contract,

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As the cost of alternative sources of water has increased, the water rights of Ventura have become more valuable. These water rights were conservatively set at $5 million in 1978.

[3]Some of the major improvements made during the 1970's to the Ventura Water System which benefitted plaintiffs include the construction of 6.5 million gallons of additional storage, an 8-mile transmission main, and a pump station. In part, these and other improvements were financed by revenue bond issues totalling $6.5 million.

Ventura obliged itself to make payments for the next 65 years estimated at $58 million. Although Ventura had yet to receive any state water at the time of trial, it had made the required annual payments for capital and fixed operating and maintenance costs. Not only must Ventura make payments irrespective of whether it receives water, but the contract provides that it must levy taxes if revenues should be insufficient to meet these payments. This tax lien obviously falls only on property owners in Ventura; as a class, nonresident water users do not share the risk of this obligation. Another burden not shared by out-of-city users was Ventura's obligation to construct the necessary transmission facilities to bring water from the state system, an estimated cost at time of trial exceeding $50 million.

Because of the impact caused by the acquisition of the two water companies, in 1970 Ventura retained the consulting firm of Wilsey & Ham to analyze the water rates. The firm initially recommended and Ventura adopted a 20 percent overall rate increase. At some later point, after obtaining updated figures and doing further careful and lengthy analysis, the firm recommended: 1) another 10 percent overall rate increase and 2) the imposition of the 70 percent surcharge on outside customers. It also recommended a rate scheme recognizing three separate classes of customers: 1) residents using treated, potable water; 2) nonresidents using treated, potable water; and 3) industrial users of untreated, nonpotable water. All industrial users of untreated water also happened to be nonresidents. Ventura

subsequently enacted an ordinance adopting these recommendations. That ordinance, along with subsequent ordinances enacted in 1975 and 1977, constitute the subject of this litigation.

After the action below was filed but before trial, Ventura engaged a second consulting firm to examine its rate structure.[4] That firm, Brown & Caldwell, concluded that the rates were more than reasonable and, in fact, an even greater differential could have been justified.

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[4]At trial, plaintiffs' attorney suggested that the study begun by Brown & Caldwell in 1976 was irrelevant because the 70 percent surcharge was originally imposed in 1972. The lower court overruled the objection, agreeing with Ventura that if the study could provide a reasonable basis for the rates, there could be no complaint with the city council's action in enacting the ordinance. In other words, even if Ventura arrived at reasonable rates based on the wrong reasons, the rates would nonetheless be lawful.

The trial court concluded the rate structure was reasonable. The Court of Appeal reversed and remanded for a new trial, holding that as a matter of law a municipality is not entitled to a return on investment and that Ventura erred in calculating the amount of surcharge to nonresidents.

II

A city which acquires the water system of another community incurs an obligation to deal fairly with its customers in that community and to provide them with service at reasonable rates. (County of Inyo v. Public Utilities Commission (1980) 26 Cal.3d 154, 159.) Rates established by the lawful rate-fixing body are presumed reasonable, fair and lawful. (Elliott v. City of Pacific Grove (1975) 54 Aal.App.3d 53, 59; Durant v. City of

Beverly Hills (1940) 39 Cal.App.2d 133, 139.) Thus, plaintiffs bear the burden of showing that the rates fixed are unreasonable or unfair. (Elliott, supra, 54 Cal.App.3d at p. 60.)

A showing that rates lack uniformity is by itself insufficient to establish that they are unreasonable and hence unlawful. To be objectionable, discrimination must "draw an unfair line or strike an unfair balance between those in like circumstances having equal rights and privileges. . . . 'It is only unjust or unreasonable discrimination which renders a rate or charge unreasonable' . . . ." (Durant, supra, 39 Cal.App.2d at pp. 138-139.) Unreasonableness will be shown where the discrimination rests solely on the nonresident status of the user. (Inyo, supra, 26 Cal.3d at p. 159, fn. 4.)

Reasonableness,then, is the

beginning and end of the judicial inquiry.[5] Clearly, the fact that nonresident users of public utility service are subject to a higher rate than those customers residing within city limits does not alone prove the rate unreasonable and hence invalid. Rather, nonresidents must show that the discrimination is not based on "cost of service or some other reasonable basis." (Inyo, supra, 26 Cal.3d at p. 159, fn. 4, italics added; see Durant, supra, 39 Cal.App.2d at p. 139.)

To determine whether the rates Ventura imposed on nonresident customers were reasonable, Brown & Caldwell

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[5]As the court stated in Kennedy v. City of Ukiah (1977) 69 Cal.App.3d 545: "Municipal corporations have the authority and power to establish and operate works for supplying their inhabitants with water. They also have the power to fix the rates to be charged for the sale of the water. (Citations.) The only requirement is that such rates be reasonable. (Citations.)" (Id., at p. 552.)

compared revenue requirements (expenses,costs) properly allocable to nonresident customers with the actual revenues received from that group. To ascertain the first element, it conducted a cost-of-service analysis.

According to evidence, the cost-of-service analysis calculates the share each customer should pay for utility service proportional to actual use of the system. Revenue requirements are allocated to various classes based on each group's proportionate use of the system, including use of physical plant facilities and consumption of water, among other elements. A preliminary step in determining revenue requirements is the establishment of appropriate classes among which costs will be allocated. The next step is to calculate the costs which properly should be assessed each group. For this

analysis, two alternative methods exist: the cash basis and the utility basis. Very generally, the cash method sets revenue requirements based on actual operating and maintenance expenses plus allowable charges for system replacement, debt principal repayment, and other capital costs. The utility method also considers actual operating and maintenance expenses, but instead of looking to cash expenses such as system replacement and debt principal repayment, the method focuses on depreciation attributable to outside use and on rte of return on investment.

The utility method is commonly used to establish revenue requirements where a class of customers owned the utility and another class uses the facilities owned by the others. It is nationally recommended by the American Water Works Association for determining water rates

of municipal customers located outside a city. Brown & Caldwell used the utility method to determine revenue requirements. Significantly, the rate of return it employed was much lower than that granted a number of companies regulated by the California P.U.C. Based on its analysis, it found a surcharge of 98.5 percent was justified. Nonetheless, Ventura continued to impose the 70 percent surcharge it had established in 1972.

As noted, the utility method focuses on depreciation and rate of return on investment.[6] Depreciation is

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[6]In its opening brief, Ventura argued that a rate of return or return on investment is not a profit. However, in its subsequent answer to plaintiffs' opening brief, Ventura apparently retracted this argument and acknowledged that "[s]ome cases have referred to [return on investment], acceptably, as 'profit. '" In any event, the trial court found on rehearing that a return on investment is a profit: "We are not impressed by counsel's attempt to distinguish between a rate of return and

typically defined as a recovery of cost over the life of the facility as it is used; it does not provide for the replacement of the facility.[7] Partly for this reason, a rate of return is allowed.

In the context of the utility method, return on investment allows a municipal utility to raise necessary replacement funds and to pay debt on the system. It also allows the municipality to be compensated for having invested its money and incurred the risks associated with building and maintaining a water system. Moreover, it compensates the municipal utility for foregoing the

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a profit. The terms are synonymous. (Citations.)"

[7]The project manager of Brown & Caldwell testified that the consultants considered depreciation on an original cost basis, as is proper, rather than on the projected replacement cost of new facilities.

opportunity to use its money in some other manner. Rate of return is, in essence, payment for the use of property of another.

Municipal utilities have historically incorporated a return on investment on rates charged customers.[8] Certainly, the existence of a practice is not dispositive of its legitimacy, but while no case squarely establishes the proposition that municipal utilities may recover a return on investment through rates charged to nonresidents,

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[8]According to the August 1911 issue of Pacific Municipalities, the official monthly publication of the League of California Municipalities, the return on Pasadena's municipal light and power plant was between 9 and 11 percent on total investment; Sacramento's water system yielded an annual net return of approximately $100,000; and Los Angeles derived sufficient revenue in its first nine years of operation to rebuild the inadequate system it had acquired, to address the demands of growth, to meet the interest and sinking fund requirements of the water bonds, and still "to leave the city a profit" of about $125,000.

case law does suggest such a practice is permissible. Moreover, common sense and basic economic principles dictate the necessity of such a rule.

California cases indicate that utility rates need not be based purely on costs. In Golden Gate Bridge & Highway Dist. v. Luehring (1970) 4 Cal.App.3d 204, the court stated that "the [California] Constitution does not inhibit an entity of local government from collecting fees for services it performs and using the net proceeds of enterprises such as municipal utility systems for the benefit of its own general fund." (Id., at p. 215, italics added.) In Beard v. City and County of San Francisco (1947) 79 Cal.App.2d 753, the Court of Appeal noted "parks, playgrounds, public utilities, and other facilities in aid of health and welfare of the community . . . . may be

operated for profit." (Id., at p. 755, italics added.) Finally, according to Dyke Water Co. (1963) 61 Cal. P.U.C. 315, "it is for the local governing body to determine precise rates and whether the system should be subsidized or profitable." (Id., at p. 321, emphasis added.) Plaintiffs' contention that Ventura must provide service to nonresident customers at "cost" without an opportunity to recover a reasonable rate of return is incorrect.

Plaintiffs urge that a rule requiring municipal utilities to provide service to nonresident customers at cost is necessary to protect the interest of out-of-city users. Whereas consumers of services provided by private utilities are protected by the P.U.C., plaintiffs would have us believe nonresident users of municipal utilities are left to the mercy of the municipality. Although

judicial review of rates is not comparable to regulation by the P.U.C., it does "protect consumers against plainly unfair rates . . . ." (Inyo, supra, 26 Cal.3d at pp. 159-160.) Significantly, the present case appears to be only the second municipal utility rate case in California history. The paucity of such litigation suggests that existing law functions sufficiently. wever, even if existing law is inappropriate or inadequate, it would seem to be the Legislature's role to revise it. Despite our statement that there is no constitutional barrier to bringing municipal utilities within P.U.C. jurisdiction (Inyo, supra, 26 Cal.3d at pp. 163-167) the Legislature has to date declined to modify the existing system.

The rule sought by plaintiffs would have a negative impact on the expansion

of California municipal utilities. Without the opportunity to obtain revenue necessary for system replacement and expansion, there would be little incentive for municipal utilities to expand in order to service nonresident users. Moreover, without a chance to recover a reasonable rate of return, a municipal utility would be foolish to increase its business risk by expanding service to nonresidents without demanding a commensurate increase in return.

III

The trial court in the instant case concluded an 8.67 percent rate of return charged nonresidents was reasonable vis-a-vis the 3.0 percent return charged residents. We agree. A higher rate of return for nonresidents is justified because (1) the in-city customers (as residents of Ventura) incurred

substantial risks and obligations not shared by out-of-city users and (2) in-city sources of revenue both directly and indirectly financed the system in ways that out-of-city revenues did not. More specifically, only property of residents was subject to the general obligation and the State Water Project liens, and only Ventura and its taxpayers bore the responsibility for management of the system, for repairs and replacement in event of disaster, and for construction of the transmission system to bring state water to the city. As for a difference in sources of revenue, residents paid taxes that contributed to the system, while nonresidents did not, and only resident customers had to pay connection fees. Moreover, Ventura's city government provided support and stability for the water system over the years: general

monies of Ventura were used to provide office space and to pay salaries of the city employees who performed accounting, billing, administrative, and legal services for the water system; Ventura made a number of transfers from its general fund to the water fund at either little or no interest; and only Ventura and its taxpayers bore the responsibility for (1) management of the system, (2) repairs and replacement, and (3) construction of the transmission system to bring state water to the city. Plaintiffs contend that any contribution made from Ventura's general fund should be disregarded because it was a source of revenue from the city government and not the city ratepayers. But, the use of city funds cannot be disassociated from its citizens. When a city uses its funds to support the water system, out-of-city customers can fairly be expected

to pay higher rates. (See Dyke. supra, 61 Cal. P.U.C. at p. 321.) Second, evidence showed some of the general fund originated from taxes, and all in-city ratepayers are also taxpayers. Third, the evidence is plain that the citizens themselves bear certain significant risks. Unlike those living outside the city, residents are uniquely responsible for the general obligation bonds that built and improved the system, for the reason that Ventura must levy taxes on private property within the city boundaries if revenue is insufficient to meet that requirement. For the same reason, residents bear the risk of Ventura's long-term contractual commitment with the state to pay an estimated $58 million for water from the State Water Project.[9]

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[9]Plaintiffs contend that the issue of property tax liens arising from Ventura's general obligation bonds and

In its 57 pages of findings of fact and conclusions of law, the trial court implicitly found that a difference of rate of return was justified. It also specifically found that the rates charged nonresident customers were fair and reasonable and were commensurate with the cost of service provided for the following reasons: the costs of providing services to nonresidents were greater, in part because Ventura had to purchase more expensive water to supply the former Mound and Saticoy customers; these same nonresident customers used up surplus capacity, which had been

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its State Water Project contract is an obligation of city property owners, but not on in-city residents. Obviously, many in-city ratepayers are city property owners and hence property taxpayers. As for those in-city ratepayers who do not own their homes, it is reasonable to assume that they will bear some of the burden of an extra property tax in the form of higher rents.

previously provided by Ventura, without making any capital contributions; Ventura substantially improved the water service to the former Mound and Saticoy customers and such service fully justified the rates charged; the nonresidents have not made and do not make the same financial contributions to the maintenance of the water system as do residents; only residents are charged acreage and connection fees, which raise funds for the water system; nonresidents do not have the same obligations and responsibilities for the replacement and repair of the system in the event of disaster or to provide for the expansion to meet population growth; Ventura continues to use its general fund and its credit to support its water system; nonresidents, having foregone nothing and shared in no risk in building up the plant, cannot expect to share in the

benefits accruing from city ownership; a municipality is entitled to recover the cost of fire protection from nonresidents, standby water demand being greater by the addition of outside areas; and a municipality is entitled to earn a return on its plant and facilities devoted to nonresident users. Contrary to the Court of Appeal, we agree that most of these justifications are appropriate.

Miscellaneous Benefits

There is no question that after acquisition the former Mound and Saticoy customers immediately received substantial benefits such as improved water quality, increased water storage, upgraded fire protection due to Ventura's pumping stations, and major transmission lines. These improvements used up both reserve and growth capacity in facilities previously provided at the

expense of in-city customers.[10] If Ventura had not charged nonresident users a higher rate of return than it charged its own residents, then in-city ratepayers would be subsidizing out-of-city ratepayers for the latter group's proportionate share of these expenses.

Plaintiffs argue that it was improper to pass on the additional cost of purchasing more expensive water directly to nonresidents. They vehemently insist that whatever new water supplies benefited nonresidents who were former

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[10]Plaintiffs argue that residents alone did not pay for the facilities. They argue that all operating expenses, bond obligations, and State Water Project contract payments have always been paid solely from revenues of both resident and nonresident ratepayers. However, plaintiffs fail to realize that the vast majority of nonresident consumers did not spring into being until 1966 and 1969 #hen Ventura purchased the Mound and Saticoy companies. For some 45 years prior, only a handful of nonresidents had contributed to the acquisition, maintenance, and improvement of the water system.

Mound and Saticoy customers also benefited residents who were former Saticoy customers. This is true, but plaintiffs fail to mention that the cost allocated to nonresidents covered only the cost required to supply them. Nonresidents were not charged with the cost of supplying new expensive water to resident customers. These additional costs of in-city users were shared by all members of that class.

Plaintiffs also make much of the fact that a large portion of nonresident users are technically ineligible to receive Casitas water because they live outside the Casitas water district. This argument seems irrelevant. Irrespective of whether nonresidents actually received molecules of water piped from Casitas or molecules of other water, Ventura had to purchase the more expensive Casitas water to provide

service to these new nonresident customers.

We conclude it was proper for the trial court to justify a surcharge based on this theory. (See Beaumont Investors v. Beaumont-Cherry Valley Water Dist. (1985) 165 Cal.App.3d. 227, 232, fn. 4.)

Rate Base

Plaintiffs argue that Ventura should have excluded from rate base[11] any facilities donated by developers or financed through connection and acreage fees. Ventura contends that such a conclusion would leave it without depreciation funds sufficient to replace its entire system. According to

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[11]Rate base is the value of the property on which the utility is entitled to a return. "The rate base on which a return may be earned is the amount of property used and useful, at the time of the rate inquiry, in rendering a designated utility service." (1 Priest, Principles of Public Utility Regulation (1969) p. 139.)

plaintiffs, however, it would be inequitable to allow Ventura to earn a return on property provided by customers themselves.

Contrary to plaintiffs' contention, in this context we see nothing inequitable in including in the rate base assets that have been paid for by past ratepayers. Unlike Pacific Tel. & Tel. v. Public Util. Com. (1965) 62 Cal.2d 634, 663-665, relied on by the dissent, in this case the inclusion of such assets does not result in a double payment by past ratepayers, but rather simply permits the past ratepayers to be, in effect, credited for their past contributions to capital. If the municipal utility's proposed profit is to be accurately evaluated pursuant to the "utility method," such assets are properly included in the rate base.

The Court of Appeal also disapproved

the inclusion of the increased value of water rights. In fact, Brown & Caldwell did not employ this capitalization figure, but used the 1940 book value of $1,215,000. Accordingly, we do not have to decide whether a higher figure would have been appropriate.

The court mistakenly states that Brown & Caldwell viewed the amounts owed under the state contract as an asset instead of a liability. On the contrary, the project manager testified the firm's study treated the item as debt and did not allocate any of the principal amounts due under the contract to nonresident users.

Finally, the court noted that Ventura could not impose an in lieu tax on nonresidents. However, as the court also noted, "[t]here is nothing in the record indicating that the city ever attempted to officially impose such a

tax."

The Three-Tier Classification Scheme

It is well established that "'a utility may, without being guilty of unlawful discrimination, classify its customers or patrons upon any reasonable basis . . . . '" (Durant, supra, 39 Cal.App.2d at p. 139; see Toward Utility Rate Normalization v. Public Utilities Commission (1978) 22 Cal.3d 529, 543-544; Kennedy v. City of Ukiah (1977) 69 Cal.App.3d 545, 553-554.) The trial court found Ventura's three-tier classification scheme to be fair and reasonable. Plaintiffs, however, objected to Ventura's three-tier classification scheme based on what it perceived to be a feigned distinction in treating users of nonpotable, untreated water as a separate class.

Plaintiffs make much of the fact that the first consulting firm Ventura hired

initially recommended a surcharge of 38.8 percent based on a two-tier classification: out-of-city water users (both industrial and domestic) and in-city users. Later, after reanalyzing and updating the data, the firm concluded a three-tier classification scheme was more appropriate and subsequently found a 70 percent surcharge more accurate. It is difficult to imagine a more natural or obvious classification. The cost of supplying treated water is indisputably very different than the cost of untreated water. The classification seems patently reasonable.

IV

Plaintiffs argue that as a matter of law the 70 percent surcharge violates Government Code section 54514, which requires the local agency to provide

water "at the lowest possible cost consistent with sound economy, and prudent management, and the security and payment of the principal and interest of the bonds." (Gov. Code, # 54514.) Although section 54514 does require that the agency furnish water "at the lowest possible cost," such language is hedged by references to "sound economy, " "prudent management," and interest to bondholders. These references clearly give a local agency considerable discretion in balancing its own financial concerns against the requirement of low rates. Moreover, prudent management and sound business judgment would seem to mandate some sort of return on investment. First of all, a municipal utility would be foolish to increase its business risk by expanding service to nonresidents without getting some type of return commensurate with

the increased risk. Second, a city that spends its funds to provide service to nonresidents and only recovers the cost of those funds is investing its money poorly. Instead of getting zero return by investing those funds in its own water system for the benefit of nonresidents, the city should invest elsewhere and get even a minimum return. Thus, "lowest possible cost" cannot be read to mean "break-even cost"; rather, it would seem only to bar unreasonable or excess profits. It is not for the court to determine what constitutes sound economy and prudent management, but only to determine the narrow issue of whether the rates imposed are reasonable. (See County of Inyo v. Public Utilities Commission, supra, 26 Cal.3d 154; Durant v. City of Beverly Hills, supra, 39 Cal.App.2d 133; see also, American Microsystems, Inc. v.

City of Santa Clara (1982) 137 Cal.App.3d 1037.)[12]

Plaintiffs also argue Ventura

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[12]In American Microsystems, Inc. v. City of Santa Clara, supra, 137 Cal.App.3d 1037, ratepayers of a municipal power utility owned and operated by Santa Clara sought to compel that city to pass on to consumers certain savings in the cost of purchasing electrical power. The Court of Appeal rejected this argument, in spite of a provision in the utility's contract with the federal supplier of power that benefits be "made available at fair and reasonable terms to all of its consumers at the lowest possible rates consistent with sound business principles." (Id., at p. 1043, emphasis in original.) The court noted that unlike privately owned utilities which are regulated by the P.U.C., publicly owned municipal utilities are under no mandate to pass on to ratepayers any savings realized in the cost of service. Rather, the public entity is entitled to fix its utility rates pursuant to its legislative power, and courts will intrude only when rates are shown to be unreasonable or unfair: "it is not the function of the courts to evaluate the wisdom of the City's rate-fixing decisions. In that context, we cannot determine what constituted 'sound business practices,' but may only consider that narrower legal question whether the rates were unreasonable or arbitrarily established. " (Id., at p. 1044.)

violated its obligations as a trustee. When a city acquires the water system of another community, as to the water dedicated to the use of the outside community, the acquiring city holds "title as a mere trustee, bound to apply it to the use of those beneficially interested." (City of South Pasadena v. Pasadena Land and Water Co. (1908) 152 Cal. 579, 594.) After the acquisition, the city is "under the same obligation as its grantor to continue the service and supply the water to all persons who may become entitled to it in the future . . . ." (Id. at p. 593, emphasis added.)[13]

It is clear that the trustee city

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[13]It is because of the trust relationship that consumers can "sue to enjoin rates which are themselves 'unreasonable, unfair, or fraudulently or arbitrarily established' [citation], or which discriminate without a reasonable and proper basis [citation]." (See Inyo, supra, 26 Cal.3d at p. 159.)

must continue to supply water, but there is no support for the proposition that a city must supply water at cost. In fact, Durant made quite clear that an acquiring city's trust obligation does not require furnishing water at cost but only at a reasonable rate: "When the city purchased the private plant it assumed a trust to perform the contract and meet the obligations of the private concern. . . . The obligation which the city assumed through the purchase of the system was an obligation to continue to serve plaintiff water at a reasonable rate." (Durant, 39 Cal.App.2d at p. 138, emphasis in original.)

V

Plaintiffs argue that it is a denial of equal protection for nonresident ratepayers to be separately classified and required to pay a 70 percent surcharge over rates paid by resident

taxpayers. They argue the surcharge is based solely on the nonresident status of the out-of-city customers, and that the only distinguishing factor between those who pay the surcharge and those who do not is an artificial political boundary line.

First, plaintiffs argue the nonresidents are a suspect class and therefore that we should apply the strict scrutiny test. They reason that the rationale behind the application of the "suspect class" doctrine is the political powerlessness of such groups. Because out-of-city users have no right to vote for or against city council members who set the water rates, they contend they are politically powerless and accordingly that the rationale of the suspect class doctrine militates towards its application in this case.

We have categorized only a few

classifications as suspect, namely classifications involving race, alienate, or national origin. We decline to extend the suspect class analysis here. The plaintiffs are no more powerless as customers of Ventura than they were as Mound and Saticoy customers. Although they cannot vote in Ventura elections, they can exert political influence in alternate ways: through lobbying, petitions, testimony at hearings, for example. As a practical matter, most utility rate decisions turn on rate hearings, and in fact, plaintiffs were represented by a member of the county board of supervisors at the very hearing in question. Moreover, despite plaintiffs' contention that Ventura forced them into its water system, this is not the case. As members of a mutual water company, former Mound customers were the same

shareholders who approved the sale to Ventura. The Saticoy transaction was approved by the P.U.C., and there is no evidence that a single protest was received.

Plaintiffs next argue that even if we apply the traditional rational-relationship test, they should prevail. We agree that this is the correct standard to use, but conclude that plaintiffs' argument is without merit. When social or economic regulations are involved, the rational-basis test applies. In such cases, "statutory discrimination will not be set aside if any state of facts reasonably may be conceived to justify it." (Dandridge v. Williams (1970) 397 U.S. 471, 485 (quoting McGowan v. Maryland (1961) 366 U.S. 420, 426).) The reasonableness test applied to municipal utility rates is somewhat more stringent than the bare

rational-basis test. Ventura has met the reasonableness standard; a fortiori, it passes the rational-relationship test.

VI CONCLUSION

We agree with the trial court that the rates imposed on nonresidents by Ventura are reasonable despite the fact that both nonresidents and residents received water from the same source and with the same quality of treatment. Moreover, the factors used by the trial court in resolving the issue of reasonableness are permissible criteria. In administering a public utility, such as a water system, a city acts in its proprietary capacity. (South Pasadena, supra, 152 Cal. at p. 593.) When a municipal utility acquires the private water system of another community, the resident customers should not be forced to bear any of the costs of providing

service to nonresidents. It is appropriate to pass on to the nonresident customers any extra cost the city has had to incur by way of expanding or modernizing facilities, in purchasing additional water, in increasing its business, or other similar costs. Moreover, it does not have to share the benefits for which it has already paid if such sharing is at the expense of residents. However, all these costs must be passed on at a proportional basis. For example, the nonresidents cannot be made to bear the cost of expansion or modernization properly attributable to in-city users.

The court is not required to determine all costs nor to balance them precisely against rates. Rather, it is the court's role to decide only whether a reasonable basis exists for charging different rates and whether the rates

themselves are reasonable. In the present case, we conclude the Court of Appeal erred in remanding the cause. Accordingly, the judgment of the appellate court is reversed.

GRODIN, J.

WE CONCUR:

MOSK, J

REYNOSO, J.

LUCAS, J.

PANELLI, J.

HANSEN v. CITY OF SAN BUENAVENTURA

S.F. 32091

CONCURRING AND DISSENTING OPINION BY BROUSSARO, J.

I agree with the majority, insofar as they conclude that the City of San Buenaventura is entitled to be compensated for services, facilities or capital which it contributes to the municipal utility and the ratepayers and that in lieu of such compensation the city ratepayers may be charged a lower rate than the noncity ratepayers. However, I cannot agree that the city is entitled to be compensated through discriminatory rates for claimed capital improvements and additions which were in fact financed by the ratepayers both within and without the city or obtained by donations to the water system.

In 1923 the city purchased a water

system from Southern California Edison and commenced to provide water to the city and out-of-city consumers. The purchase was financed by general obligation bonds. Although the bondholders had the right to require the city to levy taxes to pay for the bonds, it was contemplated that the bonds and the interest on them would be paid by water revenues. Over the years the city has issued similar bonds to purchase additional water systems and to obtain additional facilities. All payments of principal and interest on the bonds have been made from water revenues. An advance made by the city to the water company was repaid with interest, and so far as appears, city capital contributions have been negligible.

In 1935, the city established a surcharge on out-of-city customers requiring them to pay higher rates than

the in-city customers. From 1935 to 1952, the surcharge averaged 48 percent; between 1953 and 1972 the surcharge was 32 percent. In 1972, the city imposed a 70 percent surcharge. The instant case involves the validity of the latter surcharge.

Over the years the water system has been greatly expanded and improved, and the value of the property devoted to the system including water rights and facilities has increased greatly. The main issue presented is whether the surcharge, or most of it, may be justified on the theory that the city is entitled to a rate of return based on the value of the property in the system. In County of Inyo v. Public Utilities Com. (1980) 26 Cal.3d 154, we considered the relationship between a city water department and out-of-city users. The Los Angeles Department of

Water and Power served consumers in the County of Inyo, and the county argued that the Public Utilities Commission should regulate the rates because it was established to protect people from the consequences of monopoly in the public services industry and that, while city residents may exert political power over the rates, outside residents have no voice as voters or taxpayers, leaving them at the mercy of the city. (26 Cal.3d at pp. 158-159.) The court held that, although the Legislature could authorize the Public Utilities Commission to regulate water rates charged by a city to noncity consumers, it had not done so.

In response to the county's argument that the consumers had no control over the rates charged, the court stated: "[A] city which acquires the water system of another community incurs an

obligation to deal fairly with its customers in that community and to provide them with reasonable service at reasonable rates. (See South Pasadena v. Pasadena Land, etc. Co. (1908) 152 Cal. 579, 587-588, 594 [93 P. 490].) Such an acquiring city, as to the water dedicated to the use of the outside community, holds 'title as a mere trustee, bound to apply it to the use of those beneficially interested.' (Id., at p. 594; see Durant v. City of Beverly Hills, supra, 39 Cal.App.2d 133, 138.) Consequently, the county can sue to enjoin rates which are themselves 'unreasonable, unfair, or fraudulently or arbitrarily established' (Durant v. City of Beverly Hills, supra, 39 Cal.App.2d 133, 139), or which discriminate without a reasonable and proper basis (Elliott v. City of Pacific Grove, supra, 54 Cal.App.3d 53, 59). 4"

Footnote 4 states: "A showing that rates are discriminatory is in itself insufficient to fulfill the complainant's burden of proof (see Durant v. City of Beverly Hills, supra, 39 Cal.App.2d 133, 138); a showing, however, that such discrimination rests solely on the nonresident status of the customer, and not on the cost of service or some other reasonable basis, will prove the rate invalid (see Elliott v. City of Pacific Grove, supra, 54 Cal.App.3d 53, 59)." (26 Cal.3d at p. 159.)

When new users come into a municipal utility system, the city may properly charge connection fees or other charges to defray the cost of the facilities needed to serve the new users. (E.g., Associated Homebuilders v. City of Livermore (1961) 56 Cal.2d 847, 851 et seq.; Beaumont Investors v. Beaumont-

Cherry Valley Water Dist. (1985) 165 Cal.App.3d 227, 233.) However, County of Inyo, supra. 26 Cal.3d 154 makes clear that once a municipality chooses to dedicate its water service to consumers outside the city, it becomes a trustee bound to use the system for all of those beneficially interested, and any discrimination between consumers must be based on the cost of service or other reasonable basis. The lack of political power of out-of-city residents may not furnish a basis for discrimination but requires the city to act reasonably in setting their rates. They are not second-class consumers but entitled to the same rights as other ratepayers.

Accordingly, we must determine whether the record shows that the discriminatory rates are based solely on the nonresident status of the consumers and not on the cost of service or some

other reasonable basis. It is not claimed that the surcharge can be justified on the ground that it is more expensive to deliver water to the out-of-city consumers than the in-city consumers. Most of the out-of-city users live in islands of unincorporated territory surrounded by the city or areas adjacent to the city and the facilities used to deliver the water are the same for both types of users. Rather, most of the surcharge is sought to be Justified on the basis of extra charges for the acquisition of water or for facilities serving the system.

As the majority recognize (ante, p. __ [typed opn., p. 12]) and as the evidence established, there are two alternative methods for determining the revenue requirements of a utility, the cash basis and the utility basis. Under both methods the water company is

entitled to recover all of its operating and maintenance expense, including any taxes. Under the cash basis, the utility may add charges for system replacement, debt service expenses (principal and interest) and other capital costs, including additions to the facilities or reserves for additions. The total of the charges become the revenue requirement.

Under the utility basis, charges for capital replacement, additions, reserves for additions and debt repayment are not included; rather, the utility recovers for depreciation of its plant and a rate of return on its rate base or investment. (See City of Los Angeles v. Public Utilities Commission (1972) 7 Cal.3d 331, 336, 346-347.)
Under the utility basis, it should be improper to include in the rate base capital assets donated or paid for by

the ratepayers because such assets may not be viewed as investment. The point is illustrated by Pacific Tel. & Tel. Co. v. Public Util. Com. (1965) 62 Cal.2d 634, 663-664. There the Public Utilities Commission concluded that Pacific could properly include in its rate base its gross working cash requirement but the commission disallowed various additional cash sums held by Pacific which had been collected from customers in advance, from funds collected to pay debenture interest, and from taxes withheld from employees. The disallowed sums exceeded the working cash requirement. The court approved as sound and fair the commission's view that when the funds supplied by "'others than investors are greater than the amount required . . . for working cash, and the excess amount is not deducted from rate base, customers would be

unreasonably required to pay a return on funds supplied by them to defray reasonable expenses and taxes [and debenture interest] and to provide a reasonable return on invested funds.'"

The principle is clear. The utility may not be permitted to include in its rate base donations or assets supplied by the ratepayers because to allow inclusion in rate base would permit "a double return." (Id. at p. 664.)[14] It

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[14]The Court of Appeal in the instant case in an opinion by McMahon, J., assigned, reached the same conclusion on the basis of other authorities. The court stated: "The Donated Property Should Have Been Excluded From the Rate Base. Customer donations of plant are normally excluded from the rate base on the theory that it would be inequitable to permit the utility to earn on property provided by the customers themselves. (Conejo Valley Water Co. (1965) 64 P.U.C. 212, 225; La Puente Cooperative Water Co. (1966) 66 Cal.P.U.C. 614, 626; Sutter Butte Canal Co. v. Railroad Com. (1927) 202 Cal. 179, 190-191 [259 P. 937] (affd. 279 #.S. 125 [73 L.Ed. 637, 49 S.Ct. 325]); Public Utilities Commission v. Northwest Water Corp. (1969) 168 Colo. 154 [451 P.2d 266, 276-277]; Application

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of Kaanapali Water Corp. (Hawaii #pp. 1984) 678 P.2d 584, 590-592; United Gas Corp. v. Mississippi Public Service Com'n. (1961. 240 Miss. 405 [127 So.2d 404, 412]; Cogent Public Service v. Ariz. Corp. Com'n. (1984) 142 Ariz. 52 [688 P.2d 698, 701-703].) "An 111inois court reasons that it is proper to exclude contributions in aid of construction made by customers; the propriety of a reasonable depreciation deduction is not dependent upon the source of funds for the original construction of the facility, as the utility will have to replace obsolete properties. (Du Page Utillty Co. v. 111inois Commerce Comm. (1971) 47 111.2d 550 [267 N.E.2d 662, 668-669], cert. den. 404 U.S. 852 130 L.Ed.2d 62, 92 S.Ct. 74].) However, most courts reason that the purpose of depreciation is not to replace property but to recover the original investment over the life of the property. 'Since the company has invested no funds in contributed property, it is not entitled to recover the original investment through depreciation. . . . We believe it inequitable to allow a company to recover depreciation accruals on plants in which it has made no investment.' (Mechanic Falls Water Co. v. Public Utilities (Me. 1977) 381 A.2d 1080, 1104; accord State ex rel. Martigney Creek Sewer Co. v. Public Service Commission (Mo. 1976) 537 S.W.2d 388, 399; State ex rel. Utility Commission v. Heater Utilities (1975) 288 N.C. 457 [219 S.E.2d 56, 62]; Sunbelt Utilities v. Public Utility Commission (Tex. 1979) 589 S.W.2d 392, 395; Princess Anne

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Utilities Corporation v. Commonwealth ex rel. State Corporation Commission (1971) 211 Va. 620 [179 S.E.2d 714].)
"What about federal grants and funds derived from federal revenue sharing? One court has reasoned that 'the city has unqualified ownership of the portion of the plant built with the money and the fact that some infinitesimal portion of the money might be considered to have come from taxes paid by the out-of-city consumers does not create equities in their favor.' (City of Covington v. Public Service Commission (Ky. 1958) 313 S.W.2d 391, 393.) On the other hand, a Wisconsin court, in a valuation proceeding, excluded federal contributions on the theory that the federal grant was made for the benefit of both the town and the city and ". . . the city should not now be heard to claim that they should receive compensation for a portion of the water utility which was never paid for by them either directly or indirectly.' (City of St. Francis v. Public Service Commission (1955) 270 Wis. 91 [70 N.W.2d 221, 225-226].)
"Most courts which have considered the problem have excluded federal grants from the rate base. (See, e.g., Pichotta v. City of Skagway (D.C. Alaska 1948) 78 F.Supp. 999, 1006 [$39,973 expended by army in rehabilitating the system during World War II was excluded from the rate base, as the rule allowing additions was never intended to embrace a gratuitous contribution to capital made at the taxpayers expense], In re Southern California Edison Co. (1954) 53

is only the investment made by the utility which may be included in the rate base.

So far as appears in the instant case there has been no substantial investment of capital in the water system by the city. Although the city

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Cal.P.U.C. 385, 410; 6 P.U.C.3d 161, 185-186 [donations from governmental entities were not 'investment']; City of Detroit v. City of Highland Park (1949) 326 Mich. 78 [39 N.W.2d 325, 333] [federal funded contributions were excluded from rate base of municipally owned utility]; City of Hagerstown v. Public Service Commission (1958) 217 Md. 101 [141 A.2d 699] [in setting rates to utility serving outside customers, both customer contributions and federal grants were excluded from the rate base].)

"We agree that both acreage fees, connection fees, and other donations should be excluded from the rate base, in calculating any surcharge to nonresidents. As to federal contributions and grants, the same result should obtain; it is unfair to require those who have paid federal income taxes to pay for the proverbial 'pork barrel' a second time." (Fn. omitted.)

initially advanced funds to the water system, the advances were treated as a loan by the city rather than a capital investment and were repaid with interest.

The majority suggest other bases for concluding that the water facilities may be viewed as investment by the city warranting establishment of a rate base and justifying the city receiving a rate of return which can be used to reduce rates paid by city customers.

First, it is urged that the city is entitled to claim the assets of the system as investment because payment of the bonds used to acquire many of the assets and the State Water Project obligations was guaranteed by the residents of the city whose property was subJect to taxes if the water company could not pay the bonds or obligations. However, it is clear that it was always

contemplated that the principal and interest on the bonds and the project obligations would be paid from revenues of the water system and in fact that is what has occurred. In the absence of any significant capital contribution by the city, it is unreasonable to permit the city to establish the assets acquired by the bond funds or the project obligation to be viewed as investment by the city rather than the ratepayers.

Second, the city points out that it has provided services and facilities to the water system. As pointed out at the outset of this opinion, I agree that the city is entitled to be compensated for any services or facilities made available to the water system and rather than accept compensation the city may properly discount the rates charged in-city consumers. However, the discount

should be reasonably related to the value of services and facilities. It is not. The discount was more than 10 times the amount which the city claimed as the value of its services and facilities made available to the water company.[15] Because the discount, so far as appears, greatly exceeded the value of the services and facilities contributed by the city, there is no reasonable basis to conclude that the city's contributions of services and facilities furnished substantial investment capital warranting a rate of

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[15]The additional revenue due to the 70 percent surcharge during the fiscal years 1972-1973 through 1976-1977 totalled approximately $1.4 million. During the period the ratio of city consumers to out-of-city consumers ranged from approximately five to one to six to one. Assuming, as the majority conclude, that the out-of-city consumers paid a reasonable rate, the discount allowed city consumers from the reasonable rate would be at least $7 million (5 x $1.4 million). During the period the city claimed unreimbursed expenses of $629,000.

return. The trial court found that over the years the water system has "generally proven to be self-sustaining." To allow a rate of return based on the city services and facilities would permit the city a double recovery.

It is also argued that. the water system was built on the basis of revenues obtained from ratepayers and that when the city added new ratepayers the old ones who helped build the system were entitled to a rate differential based on the value of the existing system. However, this is not the basis of the discriminatory rates. Thus, when in 1969 the city acquired the Saticoy Water Company, 60 percent of the Saticoy consumers were city residents and 40 percent nonresidents. Only the nonresidents paid the surcharge; the 60 percent of the new users who were city

residents paid the discounted rate. The converse is also true; "old" users outside the city are required to pay the surcharge. Prior to the Saticoy acquisition, about 1,000 of the service connections were outside city limits with 12,600 within the city.[16] The 1,000 noncity consumers, the "old" users who helped to pay for the system, are required to pay the surcharge unless their property was annexed to the city.

It is also implied that the discrimination may be justified because after the purchase of the out-of-city companies the consumers of those companies received improved service and water quality. Fixing utility rates on the basis of the value of the service provided would be a repudiation of our long history of determining utility

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[16]After the acquisition, there were apparently 18,000 city customers and 2,800 customers outside the city.

rates on the basis of cost.

The record here is clear that the system has been paid for and is being paid for by the ratepayers, both within and without the city, and the city has not made a significant capital contribution warranting the establishment of a rate base composed of the assets of the system and an allowance of a rate of return on that rate base. When the ratepayers have paid for the system, requiring them to also pay a rate of return to the city on the assets of the system in the absence of a significant capital investment is to charge them twice for the investment. Although the rate of return may be used for replacement, improvement and additions to the system, it is improper to discriminate against the out-of-city consumers by requiring them to furnish excessive amounts for those purposes.

Rather, when the city chose to dedicate its system to serve out-of-city consumers, they became entitled to the same rights as to reasonable rates as the city users. Discrimination in rates can be justified on the basis of differentials in cost in delivering water or on the basis of city contributions but not on the basis of fictitious capital contributions.

BROUSSARD, J.

I CONCUR.

BIRD, C.J.

HANSEN v. CITY OF BUENAVENTUHA

S.F.32091

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TRIAL COURT & NO.:Ventura County

Superior

No. 55759

TRIAL JUDGE:Honorable Robert D. Carter

Supreme Court

FILED
FEB -5 1987
Laurence P. Gill, Clerk

ORDER DUE February 27, 1987

ORDER DENYING REHEARING

LA No. 32091

In the Supreme Court of the

State of California

IN BANK

HANSEN Et Al.

v.

CITY OF SAN BUENAVENTURA

Appellants' petition for rehearing

DENIED.

/s/ Broussard

Acting Chief Justice

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION SIX

COURT OF APPEAL-SECOND DIST.
FILED
APR 8 - 1985
CLAY ROBBINS, JR. Clerk

2d Civil No. 6788
(Super. Ct. No. 557)
(Ventura County)

[OPINION]

MAGDALINE M. HANSEN, et al.,

Plaintiffs and Appellants,

v.

CITY OF SAN BUENAVENTURA,

Defendant and Respondent.

May a municipally owned water system impose a 70 percent surcharge upon the water bills of customers living outside of the city limits when the cost of

providing water service has been funded by water revenues, and not taxes?

We conclude that the answer to this inquiry is found in venerable common law rules and, accordingly, decline to consider the constitutional arguments advanced by the parties.

At common law, a privately owned utility which had a monopoly in serving a given area was required to serve all consumers without unreasonable discrimination in rates or manner of service. Although such private utilities are subject to regulation by the Public Utilities Commission, customers of municipally owned utilities are just as protected from exorbitant rates and unjust discrimination as the consumers are under the Public Utility Act. Indeed, when a municipality proposes to acquire a water company subject to the jurisdiction of the

Public Utilities Commission, the commission will impose, as a condition of its approval of the sale. a provision that the city shall not unfairly discriminate against customers who live outside the city and who have no voice in city government.

It is apparent that the trial judge gave little weight to these settled principles of California law, and relied instead upon other rules of law applicable in other states, but not California. For the reasons stated, we will remand the matter for a new trial consistent with the principles enunciated herein.

THE CASE

In 1972 the City of San Buenaventura (hereinafter referred to as "Ventura" or "the city") enacted an ordinance imposing a 70 percent surcharge upon water supplied to existing customers

living outside city limits. This prompted a rebellion, and in 1973 a class action was filed seeking declaratory relief and damages on the ground that the rates imposed upon customers outside the city limits, after July 1. 1972, were exorbitant, unreasonable, arbitrary and discriminatory, and did not bear any relationship to the actual cost of furnishing water.

As is customary in water cases, the matter languished for several years. (See e.g., City of Los Angeles v. City of San Fernando (1975) 14 Cal.3d 199. 207-208.) After a nine day trial in 1978 the trial judge then considered post-trial briefs before filing his intended decision in 1980. Prolix findings of fact together with a judgment were filed in 1981. This appeal followed.

The trial court concluded that the

rate structure was reasonable. While we are, of course, obliged to uphold this conclusion if it is supported by substantial evidence, we are also guided by what Justice Holmes said in K#dd v. Alabama (1903) 188 U.S. 730. 733: "What is reasonable is a question of practical details into which fiction cannot enter."

THE HISTORY OF THE SYSTEM

Prior to 1923 the City of Ventura and adjacent territory was provided water by the Southern California Edison Company, a private company. That year the city authorized the issuance of general obligation bonds in the amount of $250,000 to purchase the system.

In 1925, 1927, 1948 and 1960 additional general obligation bonds totalling over 3.5 million dollars were issued and the proceeds were used to

improve and modernize the system. Although all property within the city was subject to a lien, and the city would have had to raise taxes if the funds generated from water revenues had proved insufficient to pay the bonds, in actuality, both operating costs and payments of bond principal and interest were always paid from available water revenue, and not from ad valorem taxes.

Indeed, annual financial reports issued by the city repeatedly stressed that its water department was operated on an "enterprise basis," and that the department generated sufficient funds through user fees to finance the acquisition, operation and maintenance of its facilities.

In 1966 the city purchased the Mound Mutual Water Company for $62,500 from water revenues. The water was of poor quality, exceeding a thousand parts per

million of total dissolved solids. Under water quality standards promulgated in California, the acceptable limits are 1500 parts per million, and the health department will only issue a temporary certificate if the water contains 1000 parts per million. After Mound was acquired, the city abandoned wells which had served the customers of the private water company and began supplying them with water of better quality.[17]

In 1968, the city acquired the

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[17]Interestingly, in calculating the value of the system, Mr. Stetson, one of the city's experts, opined that the city had an entitlement to the "Mound Basin," or 40 percent of the indigenous water rights. Because the "Mound Basin" and the "Ventura river" provided a cheaper source of water, as compared with the supply obtained from Lake Casitas, it these water rights were given a capitalized value, they would be worth $2,000,000, or 40 percent of the total water rights. However. we are not told whether the Mound Basin is coterminous with the previous boundaries of the Mound Mutual Water Company.

Saticoy Water Company ("Saticoy"). a private water company regulated by the Public Utilities Commission. Before Saticoy was acquired, only 1,025 of the 13,681 service connections of the municipal waterworks were outside city limits. With the addition of Saticoy's customers. although the number of customers within city limits increased slightly to 15,215. the number of Customers living outside city limits almost trebled, increasing to 2,711.[18]

A perusal of the map indicates that the present boundaries of the city resemble a partially completed jigsaw puzzle; many of the county residents provided with city water live in various enclaves, surrounded by areas previously annexed to the city.

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[18]By 1976-1977, following residential growth and annexations, there apparently were 18,513 city customers and 2911 customers living outside city limits.

The acquisition of Saticoy was financed by 2.5 million dollars in revenue bonds which constitute a first lien on the revenues of the water department. The bond holders could not make recourse either to the taxing power of the city or to money derived from the levy and collection of taxes. Subsequently, an additional 4 million dollars in revenue bonds were issued to provide for the replacement of deteriorated transmission and distribution lines and to prepare the system for waters expected to come from the State Water Project.

Saticoy customers benefited from the sale. Instead of relying on four small storage tanks. they now could take advantage of a city system which provided over 50 million gallons of storage capacity from tanks and a reservoir tied into the Ventura water

system. Water obtained from Saticoy's wells also was of poor quality. One well was abandoned and one well was put on a standby basis. Citizens now complain when water is pumped from this well during the summer.

The 1968 contract of sale between Saticoy and the city, which was approved by the California Public Utilities Commission, allowed the city to alter the preexisting rates at any time after 60 days. The contract further provided: "City agrees that from and after the closing date it will serve water without unfair or unreasonable discrimination to all customers in the area wherein seller is certificated to provide water service by the California Public Utilities Commission whether such customers are located within or without the territorial boundaries of the city and will continue to serve all of such

customers."

Indeed, under the Revenue Bond Law of 1941, the city shall prescribe, revise, and collect such charges that the services, facilities, or water are furnished at the lowest cost consistent with sound economy, and prudent management, and the security and payment of the principal and interest of the bonds. (Gov. Code. # 54514.)

The city has taken the position that the creation of separate pressure zones for rate making purposes would be costly to establish and politically divisive. Nevertheless, since 1935, the city has imposed a surcharge on nonresident water users. Until December of 1952, the surcharge was 48 percent.[19] Thereafter,

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[19]In 1943 the California Railroad Commission, at the city's request, issued an advisory opinion wherein it concluded that the rate differential produced a reasonable rate of return on rate base, which apparently included monies from donations and federal funds.

until July 1, 1972. the surcharge varied between 31.4 percent and 32.7 percent. Since July 1, 1972, the surcharge has been 70 percent. In fiscal year 1976-1977, this resulted in outsiders paying an average of $97.13 more than their neighbors living within city limits. If they annexed, the surcharge would be eliminated, but acreage and connection fees would be paid by the developer.

Before considering the rate increase of 1972, it is appropriate to consider the sources of money used to improve the system apart from the bonds. First, there was an intra-city loan of $245,000 in 1958 to the water department which was repaid, without interest in 1967 and 1971 (conversely, in 1946, $118.000 was transferred from the water fund to the sanitation fund. It was never repaid). Second, there was a $322,000 loan derived from revenue sharing funds in

1974 for improvements. It is to be repaid with interest, over five years, generating a return of $382,210. Third, between 1972 and 1976 the city received housing and urban development water facility grants totalling $1,774,889 for a transmission pipeline, the Avenue treatment plant, and other facilities. Fourth, the general fund was to loan the water department $1,380,245, for the financing of the Bailey Reservoir in 1978-1979, which was to be repaid with interest in five years in the amount of $1,560,081.87.

Since 1972 or 1973, no nonresident may connect to the system unless the property is annexed to the city and a correction fee is paid. By the time of trial, these contributions following annexation amounted to $778,000. This sum was included in the

rate base, having been contributed by those not within the city.

Turning now to the 1972 rate increase. we first note that the addition of the Saticoy customers (together with the 31.4 percent surcharge then imposed on nonresidents), produced rather dramatic results. Gross revenues for the fiscal year ending in 1970 increased 30.89 percent, while expenses only increased 16.63 percent. Net income jumped from $110,889.59 to $303,787.75, an increase of 173.96 percent. Yet, further funds were sought.

In the spring of 1970, the consulting firm of Wilsey & Ham was retained by the city to analyze the water rates. Mr. Heidrick, who was in charge of the study, recommended an overall rate increase of 20 percent, which has never been challenged. When

it came to recommending a surcharge, Mr. Heidrick initially concluded that those outside contributed $340,000 in revenue, and, after deducting a proportionate share of operating expenses, interest and depreciation, this would yield $61,000 (a 17.9 percent yield). By contrast, the city system would produce $132,000 on revenues of $1,634,000 (a 8.1 percent yield). However, this disparity was soon eliminated because Mr. Heidrick thought that county residents were being subsidized. For instance, on the basis that persons who made reservations for the city parks were persons who lived somewhere in the county, he believed that the relatively few county residents supplied with water by the city should be charged $31,000 for the use of the city parks and the swimming pool, and $1,000 for the fiesta de la Marina and

Poinsettia Festival. He also charged nonresidents with $4,000 in indirect administrative costs, and $135,000 for foregone interest on investment in plant serving the county.

Apparently, the city assumed that the study would provide justification for even a higher surcharge. However, Mr. Heidrick initially concluded that while the existing 32 percent surcharge on outside customers could be justified, any additional significant surcharge would be hard to justify on the basis of available data. He could only recommend another 6.8 percent increase in the surcharge, so that the total surcharge would be 38.8 percent.

The director of public works then came up with a novel approach; why not exclude both the revenue and expenses associated with the sale of untreated water to the oil companies? The sale of

untreated water had generated substantial revenue. Shell Oil paid between $195,241 and $266,109 for untreated water each year between 1972 and 1976. Yet, because the expenses associated with the sale of untreated water was less, this constituted a profit center. By eliminating his source of profit. the "loss" became $111,000 rather than $23,000.[20]

Mr. Heidrick concurred, and in light of the recalculated figures, recommended that the surcharge be increased to 70 percent. A grateful city council then enacted an ordinance imposing the recommended surcharge effective July 1, 1972.

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[20]Appellants' expert, Mr. Knaggs, believed that if the income and expenses associated with the sale of untreated water were added back in, only a 7.6 percent surcharge would be in order. The difference between this figure and the 6.8 percent figures chosen by Mr. Heidrick, is not particularly significant.

After the 70 percent surcharge was imposed, a funny thing happened. In fiscal year 1971-1972, a new administrative charge" of $71,744 was imposed on the waterworks and those revenues were transferred to the general fund. This sum increased each year and by fiscal year 1974-1975, $150,000 was so transferred. The same amount was transferred in the next two successive years, plus $76,442 to repay a loan from the general fund. This, of course, was in addition to free water furnished to city departments, which, if revenue had been collected, would have resulted in $31,199.79 in additional revenue in fiscal year 1971-1972 and $56,353.22 in fiscal year 1975-1976.

In the annual budget proposed by the city manager in 1978-1979, water revenues of $4,491,450 were anticipated, including $300,000 for water

connections. Projected departmental administration costs were $119,498. Nondepartmental administrative charges were $200,302, professional services were $41,700 and taxes were $32,755. The total expenses, including payments to water purveyors, the state water contract, and payments of bond, principal and interest, amounted to $3,314,681. After setting aside $140,510 required by a bond covenant, this would lead to a projected profit of $1,036,259 which was to be used to provide financing for a Reservoir.

THE CLAIMED JUSTIFICATION FOR THE DISCRIMINATION

A consistent theme emerged from the testimony of experts engaged by the city, namely that the city owned the system and was entitled to a reasonable rate of return as if the city residents

were stockholders in a private utility. They pointed out that other cities imposed surcharges and that the City of Pasadena took 16 percent of gross revenues from water and electric sales and put it in the general fund.

For instance, Mr. Heidrick believed that the city was entitled to a reasonable rate of return on its investment in plant serving customers residing outside city limits. Thus, he explained that the $135,000 which represented the surplus revenues generated by the surcharge upon water sales to nonresidents could be classified as foregone interest on investment. The foregone interest theory was based on the assumption that although the assets of the enterprise were created from water revenues contributed by both nonresidents and residents, the municipality which owned

the plant should be entitled to a return on the investment devoted to persons outside city limits, namely those who did not own the system. In fact, the $135,000 represented a 5 percent return on that part of the waterworks whose value was allocated to nonresident customers. He did not find fault with the rate of return, as a good part of the waterworks was based on historic cost, namely the cost of acquisition years before, and not the replacement cost.

Mr. Heidrick also felt that the $135,000 profit could be classified as an in lieu tax, based upon the theory that the city managed the enterprise, that city property was theoretically at risk if revenues proved insufficient to pay any outstanding general obligation bonds, and that only the city would be in a position to obtain short term

financing if an emergency arose.

When Mr. Heidrick recommended a 70 percent surcharge when he studied the system between 1970 and 1972, he admitted that he thought that a court reviewing another rate surcharge imposed by another city had actually upheld the validity of such a surcharge. By the time of trial. he became aware that the other 70 percent surcharge had resulted from a negotiated settlement of that lawsuit. Although Mr. Heidrick acknowledged that he had been laboring under a misapprehension, he was still of the opinion that a 70 percent surcharge was appropriate. He believed that the data would have justified a surcharge of 75.7 percent. If he eliminated the mistaken allowance for parks and the fiesta, it would only result in a lowering of the surcharge by 2.9 percent, and that the data still

justified a surcharge in excess of 70 percent.

Mr. Ferry testified that the city's water rate base was $21,006,505, and included $10,706,000 in long term debt (50.97%). The Public Utility Commission in 1976 had allowed a median return of 12.30 percent on the equity of privately owned water companies. The embedded annual cost of debt averaged 5.18 percent in fiscal year 1976-1976. If a rate of 12.30 percent was applied against the 49.03 percent of the rate base representing the city's equity, and if the 5.18 percent embedded annual cost of debt was applied against the 50.97 percent of the rate base financed by long term debt, the equitable composite rate of return for the city's total rate base would be 8.67 percent.

Nonresident users accounted for 14.41 percent of the total potable water

usage in fiscal year 1975-1976. Although only 10.43 percent of the hydrants were in the county, 83 percent of the property subject to county taxes were in areas where nonresident users were found, and Mr. Ferry allocated $21.164 to nonresidents for county taxes. The total revenues from nonresident potable water in fiscal year 1975-1976 was $615,778. The recorded expenses associated with service to nonresidents was $328,762, yielding a significant profit.

On the other hand by applying an 8.67 percent rate of return to the nonresident portion of the rate base, which amounted to $3,067,170 of the total of $21,006,505, an additional $265,924 would be added to the "revenue requirements," which would then total $594,686. The disparity then only amounted to $20,000, which Mr. Ferry

believed was within the "zone of reasonableness."

Under Mr. Ferry's computation. grant monies were included in the total rate base.[21] He also included $4,639,656 in the rate base. representing the capitalized value to the future payments that the city is obligated to pay under its contract with the State Water Project, even though the system is not connected to the nearest state water conduit. Note also that nonpotable water supplied to industrial users, such as Shell Oil Company and Getty Oil Company, who use 95 percent of the untreated water, was excluded from this computation. If the revenues ($374,301) and expenses ($271,972) were allocated to outside users, then revenue would

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[21]Mr. Ferry acknowledged that the California Public Utilities Commission does not allow donations to be included in the rate base of an investor-owned utility.

amount to $1,001,075, expenses would be $866,658, and there would be a surplus of $134,417. Under that analysis, only a 33.9 percent surcharge could be justified by Mr. Ferry. He also treated the $56,353 in free water as revenue foregone, and that the outside users should be charged $8,064 to make up for this lost revenue.

Mr. Jones, who served as the city's public works director, explained that the Casitas Mutual Water District provides half the water used by the system at a cost of $61.00 per acre foot. The water from Casitas lake can only be used within the boundaries of the district, which only includes the westerly portion of the city's water system. Because the city's water system is integrated, the city uses no more water from Casitas than is pumped from other sources, such as from the

submerged dam and wells on the Ventura river, which supply 25 percent of the water, certain golf course wells, which provide 20 percent of the supply, and cost $20 to $25 per acre feet. Certain other wells are used and water is also purchased from Alta Mutual Water Company, at $56 per acre feet.

Mr. Stetson, another engineer calculated that the value of the city's water rights on the basis that 6,000 acre feet would be extracted annually from the Ventura river and 4,000 per year from the Mound basin. The city could save in excess of $30 per acre feet if it used the water. Capitalizing this sum, he came to the conclusion that the value of each acre foot was $500, and the water rights would be worth $5,000,000. If that figure were used in place of the $1,221,838 used by Mr. Ferry as the

value of water rights. an 83 percent surcharge could be justified.

Overlooking the fact that a large proportion, if not a majority of those living outside city limits also are not within the boundaries of the Casitas Mutual Water District, and technically therefore could not use unblended Casitas water, Mr. Stetson assumed that when the Saticoy wells were abandoned, or put on a standby basis, the city had to purchase additional more costly water to serve these customers from the Casitas Mutual Water District. Based upon the costs associated with purchased water, in 1976-1977, the annual cost to nonresidents was $127.17 while the annual cost to residents was $71.89, thereby justifying a 76.9 percent differential in rates.

We turn now to the State Water

Project. After the voters of California approved the project, the Ventura Flood Control District reserved 20,000 acre feet of water. Because the city did not acquire its right to 10,000 feet of the 20,000 acre feet until 1970 or 1971, it must pay back the charges that accrued since 1960, and make ongoing annual payments as well. $1,785,681 has been contributed as of June 30, 1977 and, of course, each nonresident consumer contributed $1.70 for every $1.00 contributed by a city resident. Future contributions on the arrearages include $313,199 in principal and $94,550 in projected interest. Between 1977 and December 31, 2035, $3,704,757 in principal and $5,699,761 in interest will be paid in annual installments to the state. In addition, there will be operating and maintenance charges of $34,091,193 and Delta water charges of

$14,346,755. Yet even then, not a drop of state water will be delivered to the city or the customers until a 40 to 50 mile conduit is built between Castaic and existing Ventura mains, at a cost of countless millions.

Although all monies necessary to reserve the right to ultimately acquire state water were contributed by all rate payers, Mr. Ferry included a figure of $4,517,361, as the capitalized value of future payments, and then has 14.41 percent of that figure included in the rate base allocated to nonresidents, so that they must pay a return on monies previously paid. Mr. McMillan, the city's Director of Management Services, treated the fixed obligation of $4,017,955 as a liability. Yet that figure is also somehow treated as a future asset, and it, together with previous payments of $1,785,681, amounts

to an asset of $5,803,636.

DISCUSSION

I. INTRODUCTION

To persuade the trial court that it could exact a profit from nonresident customers, the city submitted briefs containing numerous out-of-state authorities. We find significant differences between the rules governing water rates in other states and the rules operative in California.

For the reader's convenience, we have canvassed and criticized these authorities in Appendix A to this opinion. Briefly stated, we find several recurrent themes. First, some municipalities charge "what the traffic will bear," unless of course the nonresident consumer is protected by a contract. Second, municipalities can exact profits from service to nonresidents, and place the profits in

the general fund.

While it is understandable that Ventura might prefer the rate making freedom enjoyed by municipalities in other jurisdictions we see no reason to adopt the reasoning of those out-of-state cases which sanction egregious forms of discrimination in municipal rate making. Certainly a politically powerless class of consumers are not going to tamely surrender their right under California law to obtain essential services at a fair price. In considering these expectations, it would seem that California public utility law would be a logical point of departure.

II. UNDER CALIFORNIA PUBLIC UTILITY LAW, POLITICAL BOUNDARIES ARE NOT RELEVANT CONSIDERATIONS IN RATE SETTING.

We acknowledge that although the Legislature could confer upon the State

Public Utilities Commission the power to regulate municipally owned utility rates, including the rates charged nonresidents, it has not chosen to do so. (County of Inyo v. Public Utilities Com. (1980) 26 Cal.3d 154. 166-167.) Nevertheless, a brief survey of our public utility law will prove to be useful.

First, a regulated public utility shall not raise any rate or alter any classification as to result in any increase in that rate except upon a showing that such a rate increase is justified. (Cal. P.U.C.. # 454(a); e.g., Dyke Water Co. (1964) 63 Cal. P.U.C. 507, 509-510 (where exhibits essential for calculation of a rate base or operating results were uncertain, unsubstantiated or improperly accounted for, the application would be dismissed).)

A public service water company appropriating water for purposes of rental, distribution or sale cannot confer upon a customer any preferential right to the use of any part of its water. (Leavitt v. Lassen Irrigation Co. (1909) 157 Cal. 82, 89; Cal. P.U.C. sec. 453(a).) Thus, stockholders obviously are not entitled to free service or preferential rates. (Application of Foothill Ditch Company (1929) 33 C.R.C. 237, 240; Narbonne Ranch Water Company No. 2 (1928) 31 C.R.C. 548. 550 (company must discontinue the practice of charging stockholders $1.25 and nonstockholders $1.50 for the same amount of water); Franscioni v. Soledad Land & Water Company (1914) 4 C.R.C. 184. 187.)

No public utility shall establish or maintain any unreasonable differences as to rates, charges, services,

facilities, or in any other respect, either as between localities or as between classes of service. (P.U.C. sec. 453(c).) Thus, each district should provide a reasonable return on the investment in that district. It would not be fair to require customers in other districts to provide more than their fair share of total earnings requirement, so that a particular district could have lower rates. (Cal. Water service Co. (1969) 69 Cal.P.U.C. 423, 429.)

At one time, the commission would suggest that political boundaries were proper criteria for different rate zones. In Residents of Kentwood v. Pacific Gas & Electric Co. (1936) 39 C.R.C. 577 (13 P.U.R. (N.S.) 400), residents of Kentwood believed they should be entitled to rates operative in incorporated towns of Ross, Larkspur

and San Anselmo in Marin County. However, the evidence established that there were only 38.5 electric customers per mile in Kentfield, as compared with 68.1 per mile in the incorporated municipalities. and revenue per mile was $2,209 in Kentfield while the revenue per mile was $4,430 in the cities. A similar, but less striking, disparity existed with respect to gas service. The commission said: ". . . Taken as a whole, the density of customers and revenue per mile of line is greater, and the cost of installation and operation per customer is less in incorporated cities and towns than in unincorporated areas, for both gas and electricity. It is equally true that the incorporated limits of cities and towns form a rather definite dividing line between areas of low cost and high cost service, which justified a differential in rates. . ."

(39 C.R.C. 577, 582.)

The commission suggested that Kentfield could procure more favorable rates through the simple process of incorporation. Until it did so, it would share the advantages and handicaps characteristic of rural districts. (39 C.R.C. 577. 582.)

On the other hand, where the proposed rates would favor customers inside city limits, and there was no difference in the method of providing water service to customers, or the expense involved simply by reason of the limits of the City of Vallejo, such a rate differential was an unfair discrimination. Hence a uniform rate was set by the commission. (Vallejo Water Company (1931) 36 C.R.C. 321, 323.)

Some 30 years ago, the Public Utilities Commission announced that it

was doing away with incorporation of a city as a reason for being placed in a lower electric or gas rate zone. In the future, for a city to improve its position as to rates, certain density and other pertinent factors were to be considered. (Pacific Gas & Electric Company (1952) 52 Cal.P.U.C. 111, 142; Pacific Gas & Electric Co. (1954) 53 Cal.P.U.C. 616, 622.) Also, territory contiguous to cities must now be reviewed periodically to determine if any newly developed territory has urban characteristics warranting consideration for either more favorable rate treatment, or for rates comparable to the adjoining cities. (Southern California Edison (1957) 55 Cal. P.U.C. 743, 761.)

In California Water Service Co. (1955) 54 Cal. P.U.C. 266 (9 P.U.R.3d 128) the City of Chico urged that its

city limits should be adopted as a zone boundary. The commission disagreed, saying: "This commission has long adhered to the premise that no distinction, without other controlling reasons, should be recognized either in rates charges customers or in rules governing service to them by reason of the fact that a political boundary, such as that determined by the limits of a city, separated one customer from another. If such a distinction were to be made, political rates, rather than service rates, might soon follow -- a condition abhorrent to the general public interest and to the clear mandate of the law that no unreasonable distinction shall exist." (54 Cal.P.U.C. 266, 269.)

Noting that there had been 26 boundary changes in Chico in 3 years, the commission found no just cause

for establishing a rate differential based upon whether the water service was rendered within or without the political boundaries of the city. (54 Cal.P.U.C. 266, 270.)

Similarly in San Diego Gas & Electric Co. (1972) 74 Cal.P.U.C. 93, the commission noted that counsel's arguments that preferential treatment should be accorded San Diego over the contiguous cities such as El Cajon, National City. La Mesa and others, were not convincing. "The use of city boundaries is frequently advocated by cities and has just as frequently been cast aside by the commission as inappropriate. . . . " (74 Cal.P.U.C. 93, 124.) The commission reminded the city that the purpose in establishing differential rate zones on a geographic basis is to reflect differences in costs of service in the most equitable manner

as practical. (74 Cal. P.U.C. 93, 124.)

The commission does not assert jurisdiction over rates charged by a city for service inside and outside its boundaries. However, it is most significant that the ommission, when it approves the acquisition of a privately owned, regulated public utility by a municipality, does afford protection to nonresident consumers. (Dyke Water Co. (1963) 61 Cal.P.U.C. 313. 321.) In that case the commission observed ". . . the transfer would not be in the public interest if discriminatory treatment by the city were to result. It is for that reason that the commission has at all times imposed, as a condition of its approval, a provision that a city purchasing a utility system shall not unfairly discriminate against customers who live outside the city and have no voice in city government. " (61

Cal.P.U.C. 315, 321.)[22]

Thus, the Public Utilities Commission, foreseeing the risk of discrimination against nonresidents, has guaranteed that they may not be treated like the "Outcasts of Poker Flat.[23]

III. IN CALIFORNIA A MUNICIPALITY MAY NOT ESTABLISH RATES WHICH UNFAIRLY DISCRIMINATE AGAINST NONRESIDENT WATER CONSUMERS, ESPECIALLY WHEN THE NONRESIDENTS ARE PROTECTED BY THE TERMS OF A CONTRACT BETWEEN THE CITY AND THE PRIVATE WATER COMPANY WHICH PREVIOUSLY

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[22]In Dyke, the evidence indicated that the City of Anaheim had used other city funds to support the system. Hence the customers living outside the city could fairly be expected to pay for the water at higher rates. (61 Cal.P.U.C. 3345, 321.)

[23]See, I, The Writings of Bret Harte, Houghlin & Mifflin, 1896, p. 14 et seq.

SERVED THEM.

If we were confronted with discriminatory water rates established by a municipal water district governed by the Municipal Water District Law of 1911, this opinion would have been mercifully brief. Although a district may establish different rates for different classes or conditions of service, "rates shall be uniform throughout the district for like classes and conditions of service." (Wat. Code. sec. 71614.) Although a city may be included within the boundaries of such a district (Wat. Code. sec. 71611), once the city is made part of this district, the district may sell such water "without preference" to a city. (Wat. Code, sec. 71611.[24] Nevertheless, it

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[24]The similarity between this language in these sections and those found in section 453(a) and (b) of the Public Utilities Code is not surprising.

appears that no specific statute regulates the rates set by municipalities operating their own waterworks. We turn then to common law

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as both measures were first enacted two years apart during the trust busting era of the first part of this century. Nevertheless, under the Municipal Water District Law of 1911, special rates have been set for property annexed to the district (Wat. Code. sec. 71615), and it has also been held that section 71614 of the Water Code is discretionary, and that the district had the statutory authority to enter into long term contracts governing rates so as to induce pulp mills to locate within the district. (Louisiana-Pacific Corp. v. Humboldt Bay Mun. Water Dist. (1982) 137 Cal.App.3d 152.) In Louisiana-Pacific it appears that the pulp companies did bear all of the cost of the initial costs for the additional facilities, paid $105,000 toward the district's fixed expenses for existing facilities, and agreed to pay a percentage of the operating expenses, which was subject to changes in a building cost index. (Id. at pp.154-155.) Nevertheless, Justice Grodin, concurring, suggested that in setting rates by contract, the district must still guarantee that the district substantially complies with Water Code section 71616, which requires revenues sufficient to pay operating expenses, depreciation, etc. (Id. at p. 163.)

rules upon that subject as they have evolved in California.

The rates charged by a municipally owned utility must be fair, reasonable, just and nondiscriminatory. (American Microsystems, Inc. v. City of Santa Clara (1982) 137 Cal.App.3d 1037, 1041; Boynton v. City of Lakeport Mun. Sewer Dist. (1972) 28 Cal.App.3d 91. 94.)

However, the lack of uniformity in rates charged to users of public utility service who reside outside city limits and those charged users within city limits is not necessarily evidence of unlawful discrimination and is not prima facie unreasonable. (Elliott v. City of Pacific Grove (1975) 54 Cal.App.3d 53, 57; Durant v. City of Beverly Hills (1940) 39 Cal.App.2d 133, 138-1391 County of Inyo v. Public Utilities Com., supra, 26 Cal.3d 154, 159, fn. 4.)

It is presumed that the rates fixed

are reasonable, fair and lawful. Thus the challengers must establish that the rates fixed are unreasonable, unfair or unlawful. (Elliott v. City of Pacific Grove. supra. 54 Cal.App.3d 53, 60; Durant v. City of Beverly Hills. supra, 39 Cal.App.2d 133, 139.) If, however, it is shown that a city set sewer charges four times the rate set for users inside city limits, based upon the nonresident status of the consumer, not on cost of service, and it appears that the system is financed by revenue, and no part will be financed through taxation, the rate will be deemed invalid. (Elliott v. City of Pacific Grove. supra. 54 Cal.App.3d at pp. 57, 59; County of Inyo v. Public Utilities Com., supra, 26 Cal.3d at p.159, fn. 4.)

In the area of economic regulation, such as rate regulation, it need only be

shown that the distinction between customers bears a rational relationship to other reasonable considerations. (Toward Utility Rate Normalization v. Public Utilities Com. (1978) 22 Cal.3d 529, 544; Wood v. Public Utilities Commission (1971) 4 Cal.3d 288, 294; Swanson v. Marin Mutual Water District, supra, 56 Cal.App.3d at pp. 523-524.)

Nevertheless, ". . . a city which acquires the water system of another community incurs an obligation to deal fairly with its customers in that community and to provide them with reasonable service at reasonable rates. (See South Pasadena v. Pasadena Land. etc. Co. (1908) 152 Cal. 579. 587-588, 594 [93 P. 490].) Such an acquiring city, as to the water dedicated to the use of the outside community, holds 'title as a mere trustee, bound to apply it to the use of those beneficially

interested. ' (Id.. at p. 594; see Durant v. City of Beverly Hills, supra. 39 Cal.App.2d 133, 138.) . . ." (County of Inyo v. Public Utilities Com., supra. 26 Cal.3d 154, 159. Emphasis added.)[25] See also People ex rel City of Downey v. Downey County Water Dist. (1962) 202 Cal.App.2d 786, 797.)

These common law rules are illustrated in Austin View Civic Association v. City of Palos Heights (1980) 811 Ill.App.3d 89. (405 N.E.2d 1256). In that case, defendant purchased two private water companies that were supplying water to residents in the unincorporated area. It also entered into a contract with the City of Alsip to obtain water which originated in the

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[25]Conversely, the relationship between a private utility company and its customers is not that of trustee and beneficiary. (Board of Commrs. v. New York Telephone Co. (1926) 271 U.S. 23, 31 (60 L.Ed. 808.)

City of Chicago. Under this contract, defendant was required to pay to the City of Alsip, who in turn must pay to the City of Chicago, a 50 percent surcharge over the normal price for water delivered to nonresidents. Defendant then elected to require nonresidents to pay 25 percent more for all water from whatever source, delivered to nonresidents. In reversing the order dismissing the class action. the Illinos court said:

". . . The business of supplying water belong to that class of enterprises upon which the public interest is impressed. [Citations.] At common law, such an enterprise, because it had a monopoly on the service provided in the area, was prohibited from charging exorbitant rates and was required to serve all of its consumers without reasonable discrimination in

rates or manner of service. [Citations.] Today, private utility companies are prevented from charging exorbitant rates or from engaging in unreasonable discrimination in rates or manner of service by statute, and are no longer subject to the common law [citation]. Though there is no statute that prevents municipal corporations that operate public utilities from acting in an unreasonably discriminatory manner, there is still the common law duty that prevents them from doing so." (405 N.E.2d 1256, 1262.)

The court noted that consumers of municipally owned utilities are just as completely protected from exorbitant rates and unjust discrimination as the consumers are under the Public Utilities Act. Hence, the test to be applied in determining whether there has been a violation of the common law right is the

same test used to determine whether a privately owned utility company is acting in an unreasonably discriminatory manner. The court said:

"When a privately owned utility is charged with unreasonable discrimination in rates, the test used for deciding the validity of the difference in rates is to determine whether the difference is reasonable, and not arbitrary, based on a consideration of such factors as differences in the amount of the product used, the time when used, the purpose for which used, or any other relevant factors reflecting a difference in costs [citations]. If the difference in rates is reasonably related to a difference in the costs of providing the service, there is no unreasonable discrimination." [405 N.E.2d 1256. 1265.)

Because the complaint alleged that

the rate structure was arbitrary and discriminatory, because it bore no reasonable relationship to a difference in the costs of providing water to nonresidents, then evidence had to be presented to refute that contention. While defendant may have had the power to enter into a contract with another municipal corporation for the purpose of procuring a supply of water, it did not have the power to enter into a contract which would discriminate against nonresidents. (405 N.E.2d 1256, 1266-1267.)

Finally, it should be remembered that nonresidents are protected by the earlier contract between the city and the private water companies. While the city is not under the jurisdiction of the Public Utilities Commission, if, after the commission has fixed the conditions of sale, the city purchases

the private water companies. the city may not disregard those conditions. Thus in Henderson v. Oroville-Wyandotte Irr. Dist. (1931) 213 Cal. 514, 526-534, where the contract guaranteed that the consumers outside the district pay the same total costs for water, the district could not impose a 50 percent surcharge for nonresident use, to substantially extend service within the district.

In Rutherford v. Oroville-Wyandotte Irr. Dist. (1932) 215 Cal. 124. cert. den. 287 U.S. 609, the Supreme Court issued a writ of mandate requiring the district to grant water service to a nonresident at the same rate charged to residents.

The district persisted in attempting to obtain additional funds for nonresidents and chose to impose a standby charge of $2.00 in addition to a standard 46.00 rate. The standby charge

was imposed whether water was used or not. Coincidentally, the district reduced the tax on lands belonging to residents from $3.00 per acre to $ .10 per acre.

The Supreme Court recognized that the standby charge imposed upon nonresidents was designed to defray additional expenses to secure additional rights for the exclusive benefit of those within the district. The court ruled that the amount chargeable against inside users in extending the works of the district could not be included in the charge made against outside users. It held that inside and outside users must be charged the same rate. (Rutherford v. Oroville-Wyandotte I. Dist. (1933) 218 Cal. 242, 250.)

With these principles in mind, we now examine the proffered justification for the surcharge.

4. ALTHOUGH A MUNICIPALITY MAY PROVIDE ITSELF WITH FREE SERVICE AND MAY ESTABLISH RESERVES, THE UTILITY MAY NOT EXCLUDE OTHER WATER REVENUES OR IMPOSE AN IN LIEU TAX OR MAKE ANY OTHER UNREASONABLE DISCRIMINATION, IN SETTING DISCRIMINATORY RATES TO NONRESIDENTS PREVIOUSLY SERVED BY A PRIVATE WATER COMPANY.

A. Free Service

There is no legal reason why a city which owns and operates its water or sewer system should take money from its own taxpayers to pay itself for the use of its own waterworks or sewers. This is simply not equivalent to the public utilities doctrine which prohibits the rendition of free public service to preferred customers. (See Gericke v. City of Philadelphia (1945) 353 Pa. 60 (44 A.2d 233, 237); Camden County v. Pennsauken Sewage Authority (1953) 28

N.J. Super. 586 (101 A.2d 361, 362); Twitchell v. City of Spokane (1909) 55 Wash. 86 (104 P. 150, 151).)

For the guidance of the trial court, the revenue associated with what appears to be a reasonable allowance for free city use should be totally excluded from the calculations. Otherwise, if, as the trial court suggested, revenue imputed to this free service was included in the overall calculation, then there is a real risk that the nonresidents would be charged with a proportion of nonexistent revenue.

B. Reserves

Municipally owned utilities may charge rates to finance needed replacement, or expansion of the facilities. (Pub. Util. Code. sec. 10003 (to complete, reconstruct, extend, enlarge and repair water facilities).) American

Microsystems, Inc. v. City of Santa Clara, supra, 137 Cal.App.3d 1037, 1040. (to create funds for new construction) Cramer v. City of San Diego (1958) 164 Cal.App.2d 168, 169,173, (funds used to pay for extending or improving the sewer system) Western Heights Land Corp. v. City of Ft. Collins (1961) 146 Colo. 464 (362 P.2d 155, 158) (rates can be established to extend the service and replace facilities outmoded by depreciation and obsolescence) City of Mt. Vernon v. Banks (Ky 1964) 380 S.W.2d 268, 271 (65 percent increase in water rates was justified to finance a sewer system. Prudent management contemplates contingencies and conserves assets needed for normal growth, maintenance and improvements) Rankin v. Chester Municipal Authority (1949) 165 Pa. Super. 438 (68 A.2d 458, 462, 464) (the

authority was committed to provide a new source of water, including a dam 40 miles away, and a pumping station. An increase in rates to provide a new source of water is not a tax) Pabst Corp. v. Railroad Commission (1929) 199 Wisc. 536 (227 N.W. 18, 20) (funds should be available to facilitate continued development, so that the quality and abundance of the supply will be well in advance of actual needs of the community) Laramie Citizens for Good Government v. City of Laramie (Wyo. 1980) 617 P.2d 474, 484 (rates should take into account the cost of construction and operation, necessary expansion, reserve for depreciation and debt retirement).

Unlike the situation in Rutherford v. Oroville-Wyandotte Irrigation Dist. supra, 218 Cal. 242, 250, the connection to the state water project will not

be merely for the benefit of city residents. If and when the actual connection is made, all consumers will equally derive whatever benefit is obtained from the additional water supply. While a private utility could not include such a contingent water supply in its rate base, there was no evidence before the trial court that the decision to reserve rights to state water was an imprudent investment, or that other less costly alternatives existed for future expansion. (See generally. Pub. Util. Code. sec. 10153.)

We part company with the city on the subject as to whether such a protected enormous expense should, by some process of alchemy, be treated as an asset for rate making purposes sufficient to justify a discrimination against nonresidents. The city had not even

begun the task of physically connecting its system to the state water project, so it cannot be categorized as work in progress. Remember too, that the Mound and Saticoy customers became city customers before the city ever began paying on its state water obligation. The nonresidents are not specially benefited by this expenditure. Yet, under the city's reasoning, they should continue to pay $1.70 for each $1.00 contributed by their neighbors who possibly live across the street, but within city limits. We do not agree.

The obvious solution, of course, is to treat this as a liability to be paid by nonresidents and residents alike. It should not be employed to discriminate among similarly situated customers.

C. Wages of Borrowed Services and Rent

When the city lends its employees to

the utility, and acts as landlord, the city is entitled to compensation. Unless the utility pays the city that which it would have to pay to private individuals for rent, management, fiscal and legal services, the utility rate payers are getting a "free ride" at the expense of city taxpayers who are furnishing the service. (State ex rel. Lloyd v. Hurd (Ohio App. 1964) 1 Ohio App.2d 447 (205 N.E.2d 116, 118), (35 percent of municipal salaries, including the auditor, solicitors, mayor, and city council salaries, were a charge against the municipal light plant) Borough of Ambridge v. Pennsylvania Public Service Utility Commission (1939) 137 Pa.Super. 50 (8 A.2d 429, 432) (salaries of all persons directly employed and a just portion of executive officers whose time is partly devoted to the business should be

included) Hastings v. Village of Stowe, Electric Department (Vt. 1965) 214 A.2d 56. 60 (municipal utility allowed expenses for renting a warehouse). However, the utility must prove that it incurred labor expenses. (See e.g., Garden Water Co. (1968) 68 Cal.P.U.C. 751, 755.) (The record did not persuade the Commission that the salary allocation percentages were in fact based upon a study of employees' time actually engaged in construction and operations).

The city did not attempt to prepare documents reallocating the proportions of city salaries attributable to water service until shortly before trial began. Its new allocation is somewhat inconsistent with its earlier statement to the effect that the water department was entirely self-supporting. While we might question the admissibility of

these documents prepared long after the services were rendered (Evid. Code. sec. 1280 (b) and (c)); see Elsworth v. Beech Aircraft Corp. (1984) 37 Cal.3d 540, 554) this evidence ultimately was received without objection.

D. Exclusion of Income and Expenses From Nonpotable Water.

While under public utility law different types of service may be separately classified, we know of no decision which allows a utility to exclude income and expenses from one particular class of customers, so as to create a feigned distinction for rate-making purposes between customers receiving the same service and who are similarly situated. Several cases demonstrate that this practice is unfair, if not pernicious.

In Marshall Durbin & Co. v. Jasoer Utilities Bd. (Alabama 1983) 437 So.2d

1014, the court acknowledged that it was not per se improper to combine a water, sewer and gas system for the purpose of rate making. However, it appeared that the gas rates were excessive and arbitrary. While the system as a whole earned 2.18 percent to 6.51 percent during the period in question, and a proper rate of return for gas services ranged from 7.79 percent to a maximum of 10.38 percent, the actual rate of return on gas service was 42.12 percent one year, 60.86 percent a second year, and 73.20 percent a third year. The court said: "A consolidated utility may establish rates which in effect, allow one component of the system to subsidize another component, where the overall rate structure is reasonable. Nevertheless, the profit on any one system may not unduly burden the customers with rates which are

unreasonable in order to lower rates for other services. (437 So.2d 1014, 1020.)

The Alabama court ruled that the gas rate was unlawful and that a customer might recover damages at common law resulting from discrimination by a utility as to rates or services. The customer was entitled to a refund. To hold otherwise would create a situation where a utility could set a clearly unreasonable, even exorbitant rate, collect it during prolonged litigation, and then be relieved of the duty to make a refund. (437 So.2d 1014, 1026.)

In Pennsylvania Public Utility Commission v. Johnstown Water Co. (1957) 19 P.U.C.3d 433, 450, the proposed rates for a company operating a gravity system for customers in areas of lower elevation and a pumping system in areas of higher elevation were discriminatory in that the proposed rates would impose

a large segment of the pumping system expense upon the customers served by the gravity system.

In Jager v. State (Alaska 1975) 537 P.2d 1100, the rate of $1.49 per MCF for residential service produced 53 percent of the total revenues and 63.8 percent of pretax profits on only 25 percent of the volume of gas sold. Conversely, the rate for service subject to interruption to cities, electric companies, and military customers was between .34 cents to .55 cents per MCF. It produced 36.2 percent of the pretax profits. Because each class of customers was responsible for roughly equal operating costs, the court directed the Public Utilities Commission to entertain the issue of discrimination in the rate structure.

The exclusion of the nonpotable revenues and expenses appears to have

resulted in a surcharge approaching 30 percent upon nonresident potable water users. This alone justifies the reversal of the judgment. "Profits of the past cannot be used to sustain confiscatory rates for the future." (Board of Commissioners v. New York Telephone Co., supra, 271 U.S. 23, 32.)

E. The Discrimination Cannot Be Justified Because Casitas Water is More Costly.

Although one of the city's experts believed that a 76.9 percent surcharge could be justified on the theory that the nonresidents created the need to purchase additional and more costly water from Casitas, we already know that the assumption is erroneous because a large proportion of nonresidents are not technically eligible for unblended Casitas water because they live to the

east of the area where the Casitas boundaries bisect the city. Yet, the theory itself is alien to public utility law.

In Butte County Water Users Assn. v. Railroad Commission (1921) 185 Cal. 218, it was claimed that a consumer of public water company had a vested right to service in preference to later customers, so that their rights were ranked, in the order of the time that each became a customer. The court said: "This is a rather novel doctrine and one whose statement alone is well-nigh sufficient for its rejection. . . [A] public utility must hold itself out as ready to serve and must serve the public or its portion of the public without discrimination or preference other than such as corresponds to difference in the value or cost of the service rendered. . . . [I]t would be most unjust and very

injurious to the state to hold that, in times of shortage the older consumers could have a full supply and the later none." (185 Cal. 218, 224-225.)

In In re Trunkline Gas Co.. 29 P.U.C.3d 1 (F.Power Comm. 1959) the utility proposed to impose an incremental charge. The commission ruled: "The commission has consistently rejected allocation methods which would, in effect, assign costs of particular main line facilities to a specific customer. Likewise, the commission has rejected methods which treat, for rate purposes, particular gas purchase contracts as being dedicated to a specific customer. Trunkline's proposed rates, based as they are upon all of the incremental costs of Trunkline's expansion project, are inherently unequitable and would tax the consumers for benefits to

be enjoyed by all of the customers of the integrated system. " (29 P.U.R.3d 1, 11.)

McGinley v. Wheat Belt Power Dist. (1983) 214 Neb. 178 (332 N.W.2d 915,), involved a situation where the district, because of increased seasonal irrigation and increased peak loads, built a new facility and created two consumer classes based on the date the customer requested the service on the theory that new customers were creating the sudden demand. In 1976 old customers paid 39 cents per unit while the new customers paid $5.02 per unit. Although the older customers used 75 percent of the power, by 1981 they paid only $5.75 while the newer customers paid $17.17. The court found no justification for the practice. While discrimination can be based on classes, the class may not be subdivided solely upon the date the service was

provided. Otherwise, a utility could impose on a new building, the entire cost of obtaining a new source of energy required by reason of the addition of the building to the service, even though the nature of the service is in all respects identical to all other commercial customers in the community. "Such a rate formula is beyond comprehension." (332 N.W.2d 915, 919.)

The court said: "This is a question of Wheat Belt determining that the least expensive block of power it purchases belongs to the first customers and the most expensive block belongs to the later customers, though Wheat Belt cannot show where any particular block of power is transmitted." (332 N.W.2d 915, 920.)

The court found the rate to be invalid and directed Wheat Belt to refund or credit the 1976 class the

proper amount, and absorb the loss in future rates.[26]

Likewise, a Washington court concluded that it would be inequitable to assess all costs to the new consumer block when benefits were received system-wide, even when the water consumption within the district did not increase. However, when it appeared that 40 percent of the water distributed through the new facilities went to the city, and 60 percent went to purveyors, it was reasonable to allocate costs on that basis. (King County Water District No. 75 v. City of Seattle (1978) 89

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[26]A related problem may exist in the context of a development. For instance, when developers contribute water facilities with excess storage capacity, and in fact use one-half of the capacity, a rate which would require them to be repaid in full by subsequent developers, would mean subsequent developers would have to bear all of the costs. (See Huntington Inc. v. Penn. Public Utility Commission (1983) 76 Pa.C. 387 (464 A.2d 601, 605).)

Wash.2d 890 (577 P.2d 567. 574).)

This is not a situation described by the Washington court, especially because the number of consumers both in and outside of the city have increased, and, if Casitas is now providing 50 percent of the water, all customers are being benefited by this particular supply. Hence, to charge existing nonresident consumers on the basis of incremental costs is patently ridiculous.

F. The Donated Property Should Have Been Excluded From The Rate Base.

Customer donations of plant are normally excluded from the rate base on the theory that it would be inequitable to permit the utility to earn on property provided by the customers themselves. (Conejo Valley Water Co. (1965) 64 P.U.C. 212, 225; La Puente Cooperative Water Co. (1966) 66

Cal.P.U.C. 614, 626; Sutter Butte Canal Co. v. Railroad Com. (1927) 202 Cal.179, 190-191 (aff'd. 279 U.S. 125); Public Utilities Commission v. Northwest Water Corp. (1969) 168 Colo. 154 (451 P.2d 266, 276-277); Application of Kaanapali Water Coro. (Hawaii App. 1984) 678 P.2d 584, 590-592; United Gas Corp. v. Mississippi Public Service Commission (1961) 240 Miss. 405 (127 So.2d 404, 412); Cogent Public Service v. Ariz. Corp. Com'n. (Ariz.App. 1984) 688 P.2d 698, 701-703.)

An Illinois court reasons that it is proper to exclude contributions in aid of construction made by customers, the propriety of a reasonable depreciation deduction is not dependent upon the source of funds for the original construction of the facility. as the utility will have to replace obsolete properties. (Dupage Utility Co. v.

Illinois Commerce Comm. (1971) 47 Ill.2d 550 (267 N.E.2d 662, 668-669, cert. den. 404 U.S. 852).) However, most courts reason that the purpose of depreciation is not to replace property but to recover the original investment over the life of the property. "Since the company invested no funds in contributed property, it is not entitled to recover the original investment through depreciation . . . . We believe it inequitable to allow a company to recover depreciation accruals on plants in which it has made no investment." (Mechanic Falls Water Co. v. Public Utilities Commission (Me. 1977) 381 A.2d 1080, 1104; accord State ex rel Martigney Creek Sewer Co. v. Public Service Commission (Mo. 1976) 537 S.W.2d 388, 399; State ex rel Utility Commission v. Heater Utilities (1975) 288 N.C. 457 (219 S.E.2d 56, 62; Sunbelt

Utilities v. Public Utility Commission (Tex. 1979) 589 S.W.2d 392, 395; Princess Anne Utilities Corporation v. Commonwealth ex rel State Corporation Commission (1971) 211 Va. 620 (179 S.E.2d 714).)[27]

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[27]The propriety of "connection fees" for water and sewer charges in general is undisputed. (Associated Homebuilders v. City of Livermore (1961) 56 Cal.2d 847; Carlton Santee Corp. v. Padre Dam Mun. Water Dist. (1981) 120 Cal.App.3d 14, 24.) A water district may use such revenues not only for operational and maintenance purposes but also to provide a reasonable surplus for improvements, extensions, and enlargements. (Carlton Santee Corp. v. Padre Dam Mun. Water Dist., supra. 120 Cal.App.3d at p. 30.) But see Beaumont Investors v. Beaumont Cherry Valley Water District (March 5, 1985, 4th Dist. No. E-00534) ___ Cal.App.3d ___, holding that to sustain a facilities fee, a district must prove that it was necessary by evidence establishing, (1) the estimated construction costs of the improvement, and (2) the basis for determining the amount of the fee allocated to the plaintiff. However, these payments are made by developers and other individual applicants for new service connections in order to defray the costs of obtaining service. By no stretch of the imagination could such payments be labeled prepaid expenses by every city

What about federal grants and funds derived from federal revenue sharing? One court has reasoned that "the city has unqualified ownership of the portion of the plant built with the money and the fact that some infinitesimal portion of the money might be considered to have come from taxes paid by the out-of-city consumers does not create equities in their favor." (City of Covington v. Public Service Commission (Ky. 1958) 313 S.W.2d 391, 393.) On the other hand, a Wisconsin court, in a valuation proceeding, excluded federal contributions on the theory that the federal grant was made for the benefit of both the town and the city and ". .

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resident. Therefore, it is not logical to employ such payments as a method of perpetuating rate discrimination against existing nonresident customers, most of whom also paid connection charges when they first obtained service from the private water company or the public entity itself.

. the city should not now be heard to claim that they should receive compensation for a portion of the water utility which was never paid for by them either directly or indirectly." (City of St. Francis v. Public Service Commission (1955) 270 Wisc. 91 (70 N.W.2d 221, 225-226).)

Most courts which have considered the problem have excluded federal grants from the rate base. (See, e.g., Pichotta v. City of Skagway (Alaska 1948) 78 F.Supp. 999, 1006 ($39,973 expended by army in rehabilitating the system during World War II was excluded from the rate base, as the rule allowing additions was never intended to embrace a gratuitous contribution to capital made at the taxpayers expense); In re Southern California Edison Co. (1954) 53 Cal.P.U.C. 385, 410; 6 P.U.R.3d 161, 185-186; (donations from governmental

entities were not "investment") City of Detroit v. City of Highland Park (1949) 326 Mich. 78 (39 N.W. 2d 325, 333; (federal funded contributions were excluded from rate base of municipally owned utility) City of Hagerstown v. Public Service Commission (1958) 217 Md. 101 (141 A.2d 699); (in setting rates to utility serving outside customers, both customer contributions and federal grants were excluded from the rate base).

We agree that both acreage fees, connection fees and other donations should be excluded from the rate base, in calculating any surcharge to nonresidents. As to federal contributions and grants, the same result should obtain; it is unfair to require those who have paid federal income taxes to pay for the proverbial "pork barrel" a second time.

Although donations per se should not be depreciated, and we recognize that there is only a gossamer thin line separating federal donations from other types of private donations, cities might be deterred from applying for federal grants for improved water works or from applying revenue sharing funds to aid one of its utilities serving nonresidents if the city elders discovered that none of the investment could ever be recouped, as depreciation, and made available for reinvestment in utility projects in subsequent years. After all, facilities built with federal funds do become obsolescent, and it is incumbent upon the city to repair and rebuild the system with funds created by the concept of depreciation. (See city of Detroit v. City of Highland Park, supra, 326 Mich. 78 (39 N.W. 2d 325, 333.) Therefore, for policy reasons, we

will allow the city to depreciate that part of the plant which was financed by federal funds.

G. Increased Value of #ater Rights

One expert added $5,000,000 to the rate base on the theory that water rights within the area served by the system could generate water at a lower cost than the amount which was obtained from Lake Casitas.

Although we acknowledge that the value of water rights owned by a privately owned and regulated utility must be taken into account in setting rates (San Joaquin Co. v. Stanislaus County (1914) 233 U.S. 454 ; San Joaquin Land & Power Co. v. Railroad Commission (1917) 175 Cal. 74, 77), we are puzzled by the suggestion that this increased value suddenly springs into being when nonresidents challenge a discriminatory

rate.[28] This is not a valuation case, or a situation where the water rights in question were paid for with tax revenues. Therefore, the inclusion of this sum would be wholly inconsistent with the rights to nondiscriminatory service found in the Mound and Saticoy contracts.

H. In Lieu Taxes

In lieu taxes have not fared too well in the history of this country.

At one time, the colonists evaded the tea duty by smuggling Dutch tea, reducing the sale of the tea of the East lndia company by almost two-thirds. To rescue the company, Lord North devised a majestic scheme by which the surplus tea piling up in company warehouses could be sold directly to America, skipping England and the English customs duty. If the duty was

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[28]See footnote 1, supra.

reduced to 3d, a pound, the tea could be sold at 10s, instead of 20s a pound. Considering the Americans known fondness for tea, the lowered price was expected to overcome their patriotic resistance to paying duty, and the duty would then generate funds to pay for the defense of the colonies.

This resulted in the Boston Tea Party. Disgruntled patriots boarded ships, slashed open the tea chests, and dumped the contents into the waters of Boston Harbor, voicing seditious thoughts, such as "no taxation without representation." And you know how the story ended.[29]

When private utilities are regulated by a public utility commission, the commission will not allow the utility to charge customers living outside

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[29]For a modern account, see B. Tuchman, The March of Folly: From Troy to Vietnam, pp. 193-196, (A.Knopf 1984).

municipal boundaries with business and occupation, or gross receipts taxes, and will instead require such taxes to be paid exclusively by the inhabitants of the city which impose the tax. (State ex rel. West Plains v. Public Service Comm. (Mo. 1958) 310 S.W.2d 925; City of Spartanburg v. Public Service Comm. (1985) _____S.C. ____ (314 S.E.2d 599); City of Houston v. Public Utilities Commission of Texas (Tex.Civ.App. 1983) 656 S.W.2d 107; Ogden City v. Public Service Commission (1953) 123 Utah 437 (260 P.2d 751); King County Water District No. 75 v. City of Seattle (1978) 89 Wash.2d 890 (577 P.2d 567, 571-573.)

In most jurisdictions, the burden of paying franchise payments is imposed upon the inhabitants of the communities which exact the franchise payment, and not upon those consumers residing

elsewhere. (City of Petersberg v. Hawkins (Fla. 1978) 366 So.2d 429; Village of Maywood v. Illinois Commerce Commission (1961) 23 Ill.2d 447 (1978 N.E.2d 345. cert.den. 369 U.S. 851); City of Des Moines v. Iowa State Commerce Commission (Iowa 1979) 285 N.W.2d; City of Norfolk v. Chesapeake and Potomac Telephone Company of Virginia (1975) 216 Va. 317 (218 S.E.2d 531); Contra State v. Department of Public Service (1943) 19 Wash.2d 200 (142 P.2d 498, 535-537); and City of Montrose v. Public Utilities Commission (1978) 197 Colo. 119 (590 P.2d 502.)

In California, private utilities do pay franchise fees regulated by the Legislature. (P.U.C., sec. 6231(c).) When San Diego, a charter city, imposed a 3 percent franchise fee, which was higher than the rate which could be charged by other municipalities, the

Public Utilities Commission required the customers within the City of San Diego to bear the increased cost in their utility bills, and would not permit the increased fee to become a general operating expense which could be levied upon customers living outside the charter city. (San Diego Gas and Electric Company (1972) 73 Cal.P.U.C. 623, 627-628.)

Thus, California utility law appears to be consistent with the rules operative in other states.

Before examining cases from other jurisdictions, allowing the imposition of so-called "in lieu" taxes, we should note that "in lieu" taxes are usually found in statutes allowing one governmental entity to collect funds from another public entity. Thus, the Federal payment in Lieu of Taxes Act (31 U.S.C., sec. 6901, et seq.) is designed

to compensate local governments from the loss of revenue from tax immune federal lands. See generally, Lawrence County v. Lead Deadwood School Dist. (1985) ___ _ U.S. ____ (105 S.Ct. 695). In lieu taxes are also collected by the Metropolitan Water District from public entities within its own boundaries. (See Wat. Code Aspen., sec. 109-306 and 109-331 et seq.; see generally City of Burbank v. Metropolitan Water District (1960) 180 Cal.App.2d 451. Yet courts tend to mistakenly view extraterritorial taxes of the type proposed by Lord North, as being simply in lieu taxes.

In some states, tax equivalent charges are permitted by statute, see e.g., Village of Fox Point v. Public Service Commission (1943) 247 Wisc. 97 (7 N.W.2d 571. 574) (sec. 66.069(c) of the Wisconsin statutes permitted a $550,000 tax equivalent

charge).

In H.P. Biggs Inc. v. Borough of Madison (1983) 188 N.J. Super 212 (457 A.2d 43), the utility only provided service within its municipal boundaries. Although it acquired its electricity from a private company at wholesale rates, it charged the same rates as the private company, instead of recalculating the cost of service. It had thereby created a surplus of $536,232 and paid in lieu taxes of $425,000 to the municipality.

The New Jersey court held that the rate was proper. A municipality could set rates within its own boundaries, and if the resident consumer voter did not like the rates, he could vote the governing body out of office. (457 A.2d 43, 48.) The court acknowledged that because the statute allowed the utility to create a surplus,

there was no reason to invalidate the tax. In reaching its conclusion, the court opined that electric utility charges should not be a substitute for general taxation. However, charges, otherwise reasonable would not be invalidated merely because they resulted in the creation of surpluses to be transferred to the budget. (457 A.2d 43. 51.)

In Rosalind Holding Co. v. Orlando Utilities Commission (Fla.App. 1981) 402 So.2d 1209, the court noted that the municipal owned utility imposed a charge of 1 percent of retail sales of electricity to customers outside the city of Orlando but within Orange County. Over several years, $1,114,000 was given to Orange County. Although no statute authorized the practice, the court noted that this was less than ad valorem taxes paid by a public utility

and that the experts had said that it was not an uncommon practice for tax exempt utilities to make tax equivalent payments.

The utility also charged a franchise equivalent fee based on six percent of the revenues earned. This yielded a payment of $1,442,561 in addition to profits of $5,542,000. Although the Florida Public Service Commission would have limited the charge to customers in cities charging the fees, the court concluded that it was not really a franchise fee. However, as no witness testified that the rates or profits were unreasonably high, the Florida court found that it was immaterial whether a franchise equivalent was charged.

In Hastings v. Village of Stowe, Electric Department (1965) 125 Vt. 227 (214 A.2d 56), the court allowed a small sum as a tax equivalent. However, it

disallowed a claim of $15,106 for federal income and state franchise taxes which, of course, were never paid, saying: "To proliferate a utilities true operating expense by the introduction of illusory charges never actually experienced would impair the regulatory process." (214 A.2d 56, 59.)[30]

In Petition of Burlington Electric Light Department (1977) 135 Vt. 114 (373 A.2d 514); a challenge was made to a $452,783 contribution in lieu of taxes, on the ground that it was a guise to redistribute taxes upon tax exempt private organizations, and various governmental agencies, including the University of Vermont, by requiring them to pay a contribution through increased

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[30]Although in lieu taxes were approved, because the total contribution from other earnings constituted 60 percent of the village budget, the Public Utility Commission could lower the rates. (214 A.2d 56, 62.)

utility bills. The court rejected the challenge, reasoning that a Vermont statute allowed municipalities a return commensurate with that allowed private utilities. Property taxes were a recognized operating expense for private utilities. Therefore, as a contribution in lieu of taxes is analogous to a proper operating expense of a private utility, it could be expected to make up for taxes lost where the municipality, instead of a private company, owned the facility. (373 A.2d 514, 516.)

Nevertheless, it should be recognized that an in lieu tax is a fiction. We are aware of no California statute which authorized a municipality to impose an in lieu tax upon nonresidents. There is nothing in the record indicating that the city ever attempted to officially impose such a tax. To the extent to which the judgment is based upon the

assumption that an in lieu tax could be imposed on nonresidents protected by their contract between the city and Saticoy, it is clearly erroneous. (Rutherford v. Oroville-Wyandotte Irrigation District. supra, 218 Cal. 242, 247.)[31]

Conversely, to the extent to which the county taxes service extensions used to furnish service exclusively to nonresidents, that burden would be borne by the outsiders. If the tax was imposed on land and facilities serving all customers, then there is no reason for any discrimination.

I. Profits

Of course, a charge for water services

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[31]See also Guy S. Atkinson Co. v. Highland Util. Dist. (1958) 158 Cal.App.2d 718, 723, where the court found it was unfair to increase the connection fee from $5.00 to $175, where the district had earlier agreed to give a refund to the developer at the rate of $184.42 per house.

is not a tax (Arcade County Water Dist. v. Arcade Fire Dist. (1970) 6 Cal.App.3d 232, 240 (charge for hydrants); Trumbo v. Crestline Lake Arrowhead Water Agency (1967) 250 Cal.App.2d 320, 322; (charge for standby water service). However, where a given rate is imposed in order to provide a fund for the general benefit of the city, and thereby enable the city to fix a lower rate for general purposes, this could constitute an unjust discrimination, rendering the charges excessive and unreasonable. (City of Madera v. Black (1919) 181 Cal. 306, 314.)

This principle is now incorporated in the California Constitution. "Under article XIII B, with the exception of state subventions, the items that make up the scope of 'proceeds of taxes' concern charges levied to raise general

revenues for the local entity." "Proceeds of taxes" in addition to "all tax revenues" includes "proceeds . . . from . . . regulatory licenses, user charges, and user fees [only] to the extent that such proceeds exceed the costs reasonably borne by such entity in providing the regulation, product, or service. . . ." (sec. 8, subd. (c), italics added.) Such "excess regulatory or user fees are but taxes for the raising of general revenue for the entity. (City of Madera v. Black (1919) 181 Cal. 306. 313-314. . . ." (County of Placer v. Corin (1980) 113 Cal.App.3d 443, 451.)[32]

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[32]See also Beaumont Investors v. Beaumont Cherry Valley Water District, supra, (filed March 5, 1985, 4th Dist. No. E-00534) ___ Cal.App.3d ___. Conversely, where a public entity has incurred obligations to the state water project before the enactment of article XIIIA of the California Constitution, taxes levied to meet those obligations are not subject to the tax limitation provisions found in article XIIIA.

Remember too, that having acquired a water works, as to the water dedicated to the use of the outside community, the city holds title as "a mere trustee, bound to apply it to the use of those beneficially interested. County of Inyo v. Public Services Commission. supra. 26 Cal.3d 154. 159.) Obviously, a trustee may not use or deal with trust property for his own profit. (Civ. Code. sec. 2229.)

Thus, unlike the many states which have sanctioned the practice of allowing a municipality to make a profit on service to customers outside city limits previously served by a private water company, California law would prohibit such a practice. Furthermore, as a general proposition, a rate which produces an excessive return is a tax,

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(Goodman v. County of Riverside (1983) 140 Cal.App.3d 900.)

and there is no California statute allowing a municipality to tax nonresidents by way of an in lieu tax, or otherwise.

Note too that under the Revenue Bond Law, the services, facilities, or waters of the enterprise must be furnished at the lowest possible cost consistent with sound economy, and prudent management, and the security and payment of principal and interest on the bonds. (Gov. Code. sec. 54514.) A rate which creates an artificial discrimination against nonresident customers would be inconsistent with this requirement.[33]

In short, where the city has agreed to serve all customers of a private

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[33]In Michigan, by way of contrast, the revenue bond statute contains no limitations as to what methods of developing rates may be used, and under other provisions of Michigan law, a municipality may include a fair rate of return. (County of Oakland v. City of Detroit (1978) 81 Mich.A. 308 (265 N.W.2d 130, 133.)

water company, including those customers located outside city boundaries, without unfair or unreasonable discrimination, it cannot establish a discriminatory rate for outsiders which is not based on true differential in cost of service. Therefore, it was not proper to allow a rate of return on outside service to justify a discriminatory rate which favored city residents. (Henderson v. Oroville-Wyandotte Irr. Dist., supra, 213 Cal. 514, 529; Rutherford v. Oroville-Wyandotte Irrigation Dist., supra, 218 Cal. 242, 247; Dyke Water Co., supra, 61 Cal.P.U.C. 315, 321.) The foregone investment theory is flawed for the same reason. Thus, where, as here, the nonresidents were existing customers of a private water company acquired by the city, and the cost of service was defrayed through revenue, rather than taxes, a surcharge would only be

justified if the costs of serving them were higher.[34]

J. Fire Protection

Because water is furnished both for general use and fire protection, the task of dividing the cost of service between the two services has always been a perplexing one. (City of Bangor v. Public Utilities Commission (1960) 156 Me. 455 (167 A.3d 6, 10); Chicopee Mfg. Corp. v. Manchester Board of Water Commissioners (1951) 97 N.H. 109 (81 A.2d 837, 839.) It is of course unavoidable that the determination of

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[34]In light of this conclusion, we will not consider the interesting question as to whether a public entity holding water subject to a "public trust" (National Audubon Society v. Superior Court (1983) 33 Cal.3d 419, 433-434; People v. Weaver (1983) 147 Cal.App.3d Supp. 23, 28-29) might be precluded from discriminating between residents and nonresidents as to user fees. (See Neptune City v. Avon By The Sea (1972) 61 N.J. 296 (294 A.3d 47, 55; 57 A.L.R.3d 983.) (Higher fees charged to nonresidents using a beach within a municipality were invalid.)

fire protection charges often involve sharp conflicts of interests between city officials, taxpayers and water users. City of Bangor v. Public Utilities Commission, supra, 167 A.2d 6, 12.)

The problem is magnified when fire protectionservices are rendered to nonresident. If the residents live in another municipality, district or simply within a county, part of their tax bill may include a provisionfor fire protection. Insofar as appellants are concerned, after 1978, the other governmental entity is not obliged to pay for the service, unless it consents to do so. (Gov. Code sec. 53069.9; Public Water Agencies Group v. Consolidated Fire Protection Dist. (1983) 145 Cal.App.3d 695.)

Because appellant did not specifically advert to this issue in the

briefs filed with this court, we will not address the point (In re Marriage of Sheldon (1981) 124 Cal.App.3d 371, 381), except to alert the trial judge who hears the retrial of this matter that it will prove to be a difficult one to resolve.

SUMMARY

Although we acknowledge our obligation to uphold rates which are within the proverbial "zone of reasonableness" (Permian Basin Area Rate Cases (1968) 390 U.S. 747, 767, citing FPC v. Natural Gas Pipeline Co. (1942) 315 U.S. 575, 585, we have concluded that in the case before us, reason was replaced by several fictions. Although the experts chosen by the city may have been among the "best and brightest",[35] they were beguiled by legal principles

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[35]See generally, D. Halberstam. The Best & Brightest, Random House (1972).

applicable in other jurisdictions, but not in California. The expert who espoused the view that the existing nonresident customers should pay the incremental costs of Casitas water not only was unaware of the facts, but he also relied upon a discredited theory. Apparently no one considered the Rutherford and Henderson cases decided by the Supreme Court more than 40 years earlier.

It appears to us that the collection of errors made by the city's experts led in turn to a flawed analysis by the trial court. For instance, even if nonresidents should contribute to defray the expenses incurred by employees whose salaries are paid by taxes, the 70 percent surcharge was also predicated upon a host of other errors, such as the exclusion of the operating results arising from the sale of nonpotable

water, or the theory that the city was entitled to a return on investment, etc. We think that a miscarriage of justice occurred requiring us to reverse the judgment and remand the case for a new trial (Cal. Cont., art. VI, sec. 13; Kuffell v. Seaside Oil Co. (1977) 69 Cal.App.3d 555, 567) and a result consistent with the principles enunciated herein (Puritan Leasing co. v. Superior Court (1977) 76 Cal.App.3d 140).

DISPOSITION

The judgment is reversed, and the cause is remanded for a new trial.

CERTIFIED FOR PUBLICATION.

McMahon. J.*

We concur:

GILBERT. Acting P.J.

ABBE. J.

*Assigned by the Chairperson of the Judicial Council

Robert D. Carter. Judge*

Superior Court County of Ventura

Stone and Stone, a Professional Corporation, and Richard C. Gilman, for Plaintiffs and Appellants.

Donald S. Greenberg, City Attorney; Michael R. Dougherty, Assistant City Attorney, Arthur L. Littleworth, Best, Best & Krieger, Special Ccunsel, for Defendant and Respondent.

*Retired judge of the superior court sitting under assignment by the Chairperson of the Judicial Council.

APPENDIX A

1. IN MOST JURISDICTIONS, MUNICIPALITIES ARE ALLOWED TO GENERATE A PROFIT FROM THEIR UTILITY OPERATIONS AND MAY IMPOSE A SURCHARGE UPON THE RATES PAID BY NONRESIDENTS.

Invariably, it is the rule that it is presumed that the municipal rates are reasonable, and the party assailing the rates has the burden of persuasion. (See e.g.. City of Pompano Beach v. Oltman (Fla.App. 1980) 389 So.2d 283, 286; County of Oakland v. City of Detroit. supra. 81 Mich.App. 308. (265 N.W.2d 130, 132); Laramie Citizens for Good Government v. City of Laramie (Wyo. 1980) 617 P.2d 474, 484; Village of Niles v. City of Chicago (1980) 81 Ill.App.3d 60 (401 N.E.2d 1235, 1242); Shawnee Hills Mobile Homes Inc. v. Rural Water Dist. No.6 (1975) 217 Kan. 421 (537 p.2d 210. 217).)

Several states take the sensible position that a municipal water system should be operated to serve its residents and that nonresidents may be served if that commitment does not endanger local service. However, such incidental service to nonresidents may not fairly be converted to an obligation to render additional nonresident service tending to jeopardize service within the municipality. (Mongiello v. Borough of Hightstown (1955) 17 N.J. 611 (112 A.2d 241, 245; 48 A.L.R.2d 1216); see e.g., Richards v. City of Portland (1927) 121 Ore. 340 (255 p. 326, 329) (service could be discontinued to customers of private water company which refused to provide storage facilities, despite a water shortage, where the water contract was for a fixed period of time and contained the reservation that the water

was supplied subject to the superior rights of the city when no surplus existed.)[36]

Other states have gone a step further, reasoning that since a governmental unit has the power to withhold service to nonresidents, it has no duty at all to them, and can establish whatever rates the traffic will bear. The following passage from a South Carolina case evidences uncommon solicitude for a local city - state and

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[36]In California a water district, empowered to declare a water shortage emergency condition, may deny new connections to preserve the supply when there would be insufficient water for human consumption, sanitation, and fire protection. (Wat. Code. sections 350, 353, 354, 356; Butte Co. W.U. Assn. v. Railroad Com. (1921) 185 Cal. 218, 230; Swanson v. Marin County Mut. Water Dist. (1976) 56 Cal.App.3d 512, 522-523.) Similarly, a sanitary district may not grant a preference in limited disposal capacity to those outside the district over its inhabitants who had a current need for such service. (Trimont Land Co. v. Truckee Sanitary Dist.(1983)145Cal.App.3d 330, 351-354.)

brings to mind medieval walled cities, where the only entrance was a fortified gate protected by guard towers, a moat, and portcullis.

Assuming the city had an obligation to sell surplus water. ". . . it did not import an obligation to make a contract with any particular person at a reasonable price; but on the contrary, it did import an obligation to sell its surplus water for the sole benefit of the city at the highest price obtainable. It was a duty not owed to outsiders, but exclusively to inhabitants and taxpayers of the city. It follows that the plaintiff, as a mere nonresident, had no rights whatever against the city, except such as he may have acquired by contract. In other words, the city was under no public duty to furnish water to the appellant at reasonable rates, or to furnish it at

all. . . ." (Childs v. City of Columbia (1911) 87 S.C. 566 (70 S.E. 296, 298).)

This doctrine finds acceptance in many jurisdictions. (See e.g.. City of Phoenix v. Kasun (1939) 54 Ariz. 470 (97 P.2d 210).) (The relationship is purely contractual and courts do not have the power to determine the reasonableness of rates charged nonresidents); (City of Englewood v. City and County of Denver (1951) 123 Colo. 290 (229 P.2d 667, 672.) (Defendant was under no obligation to serve another city at any particular rate, or at all); (Lee v. City of Colorado Springs (1957) 136 Colo. 248 (315 P.2d 822, cert. den. 355 U.S. 955; Barr v. City Council of Augusta (1950) 206 Ga. 753 (58 S.E.2d 823); Davisworth v. City of Lexington (1949) 311 Ky. 606 (224 S.W.2d 649, 651.) (Nonresidents have no lawful claim upon any city service and any use of

city facilities is wholly permissive, and the outside customers are mere licensees); (Forest City v. City of Oreoon (Mo.App. 1978) 569 S.W.2d 330, 334.) (Missouri statutes which allow water to be provided to nonresidents or to other cities on such terms as may be agreed upon by the contracting parties, have left the sale of water free of regulation).

In those types of jurisdictions the nonresident may secure protection by contracting with the municipality.[37] (See e.g.. City of Daytona Beach v. Stansfield (Fla. 1972) 258 So.2d 809, 810 (under a 1954 agreement, when the city bought a water company, the parties agreed that the rate to nonresidents

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[37]Los Angeles was held bound by a contract with the Veterans Administration providing for water at the resident rate to facilities located outside city limits. (Department of Water & Power v. United States (1945) 105 Ct. Claims 72 (62 F.Supp. 938).)

would not exceed 133 percent of resident

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rates. In upholding an order enjoining a 200 percent increase, the court reasoned that the charge to outsiders could never be less than cost unless the city elected to charge rates to its own residents which were less than cost); Copper County Mobile Home Park v. City of Globe (Ariz. App. 1981) 131 Ariz. 329 (641 P.2d 243) (when city contracted to provide sewer service at a rate equal that charged within city limits, it could not charge nonresidents a monthly service fee of $10.00 when $1.00 per month was charged residents).)

However, a fixed contractual rate such as $10.00 per annum set in 1946, may become unreasonable in the face of unforeseen inflation, and when such a low rate compromises health services, it can be replaced with just and equitable sewer charges. (Landau v. City of Leawood (1974) 214 Kan. 104 (519 P.2d

676.) Conversely, when a developer entered into a contract calling for a rate of not less than 70 cents per 1,000 gallons at a time when utility rates were unregulated, and subsequently legislation required that the rates shall be the same as those within the municipality, the contract was nullified and the persons outside could only be required to pay the same rate paid by city residents. (Weidling v. Borough of Manville (1979) 172 N.J. Super 371 (412 A.2d 133).)

Most significantly, in most jurisdictions, it has been held that city authorities may fix a utility rate which generates a profit which can be transferred to the general fund. (See e.g., Mitchell v. City of Mobile (1943) 244 Ala. 442 (13 So.2d 664, 667; City of Pompano Beach v. Oltman, supra, 389 So.2d 283, 286; Messenheimer

v. Windt (1955) 211 Ga. 575 (87 S.E.2d 402, 404-405.) (Since nonresidents are not taxpayers, they have no interest in the municipal revenues and no right to challenge a diversion of fund to retire hospital obligations. The city of Macon may operate its waterworks at a profit, and those who do not wish to use the water can cease buying it from the city.) (Wagner v. City of Rock Island (1893) 146 Ill. 139 (34 N.E. 545;[38] Shawnee Hills Mobile Homes Inc. v. Rural Water Dist No.6, supra, 217 Kan. 421 (537 P.2d 210, 218.) (In the absence of statutory restrictions, a municipality operating a water system has the authority to charge such rates as will yield a fair profit, so long as the rate

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[38]But see Ross v. City of Geneva (1978) 71 Ill.2d 27 (373 N.E.2d 1342, 1345) where the statute did not empower the city to levy a 10 percent surcharge on commercial electric users and then use funds for the construction of parking lots.

is not disproportionate to the service rendered); (Township of Meridian v. City of East Lansing (1955) 342 Mich. 734 (71 N.W.2d 234, 236, 238.) (Although the contract provided for reasonable rates, and statute provided that nonresidents should not pay more then double the rate paid by residents, an 87-1/2 percent surcharge was proper because the city was entitled to a fair return. The court reasoned that a city's purchase of a utility plan is made on behalf of its citizens, who then become both consumers and owners. A requirement that nonresidents be charged at the same rates defeats the purpose of the purchase); (Apodaca v. Wilson (1974) 86 N.M. 516 (525 P.2d 876.) (The city rates compared favorably with amounts received by private utilities. The city was not obliged to provide service at cost and could make a profit. Hence, of the

$1,505,233 derived from increased sewer and water revenues, $1,129,903 could be transferred to the general fund); (Village of Boonville v. Maltbie (1936) 272 N.Y. 40 (4 N.E.2d 209, 212.) (Although a surplus of $249,000 existed, the court reasoned that privately owned utilities must be allowed a reasonable rate of return, even if they had no indebtedness. The commission should not treat a municipality in a different fashion and deny it a profit); (City of Niles v. Union Ice Corp. (1938) 133 Ohio St. 169 (12 N.E.2d 483.) (As long as the rate is reasonable, courts cannot prohibit a municipality from making a profit); (Kliks v. Dalles City (1959) 216 Ore.160 (335 P.2d 366, 373). (O.R.S. 225,020 authorizes a city to operate a waterworks "for profit" and the fact that the city makes a profit does not show that the rate is

unreasonable). (Shirk v. City of Lancaster (1933) 313 pa. 158, 167 (169 A. 557, 561-562; 90 A.L.R. 688); Simons v. City Council of Charleston (1936) 181 S.C. 353 (187 S.E. 545, 547).) (A municipality may charge a rate which will yield a fair profit, just the same as a private corporation. The fact that it makes a profit does not show that the rate is unreasonable); (Killon v. City of Paris (195!) 192 Tenn. 446 (241 S.W.2d 524. 526.) (As the city has a right to make a profit in furnishing water to customers, revenues could be used to pay all the city's bonded indebtedness); (San Antonio Independent School Dist. v. City of San Antonio (Tex. 1976) 550 S.W. 2d 262, 264-265.) (Under Vernon's Annotated Statutes of Texas, article 1113a, profits can be transferred to the general fund and a city could receive almost 23 percent of

its budget requirement from its gas and electric systems); (City of Newport News v. Warwick (1932) 159 Va 571 (166 S.E. 570, 579; 167 S.E. 583).) (Twitchell v. City of Spokane (1909) 55 Wash. 86 (104 P. 150, 151.) (The city owns the water and the fact that a profit is made from other customers does not necessarily show that the rate is excessive).

If the city is entitled to divert water revenues, will not the city soon become as rich as Croesus, by exacting a profit from sales made to nonresidents? In Rosaland Holding Co. v. Orlando Utilities Commission. supra, 402 So.2d 1209, 1212, fn. 19, the court said, in passing: "The city of Jacksonville receives 30% of its utility's gross income. In an extreme case, there may arise the specter of a tax-free town made wealthy by its utilities operations inside and outside its political

limits."

Yet, the prevailing view in most jurisdictions is that the charges of a municipal waterworks are for a commodity sold and are not taxes. (Chicopee Mfg. Corp. v. Manchester Bd. of Water Commissions (1951) 97 N.H. 109 (81 A.2d 837, 839); Daniel v. Borough of Oakland (1973) 124 N.J. Super. 69 (304 A.2d 757, 759); Apodaca v. Wilson, supra. 86 N.M. 516 (525 P.2d 876, 885; Simons v. City Council of Charleston, supra, 181 S.C. 353 (187 S.E. 545, 547); Twitchell v. City of Spokane, supra. 55 Wash. 86 (104 P. 150, 151); see also Louisville and Jefferson County Metropolitan Sewer District v. Joseph E. Seagram & Sons (1948) 307 Ky. 413 (211 S.W.2d 122, 125; 4 A.L.R.2d 588 (sewer rate isn't a tax).) In City of Niles v. Union Ice Corp. (1938) 133 Ohio St. 169 (12 N.E.2d 483, 489), the court reasoned as

follows:

"The rate charged in excess of cost is not a tax or in the nature of a tax, regardless of how the fund derived therefrom is ultimately used. A municipality, acting in a proprietary capacity, cannot impose taxes. While thus engaged, it is engaged in business but not in the business of government. . . . Since the rate charged is not a tax in its inception, ultimate use of surplus funds derived therefrom for the support of municipal government will not convert it into taxes or cause it to assume the nature of taxes."

Of course, when the service is confined within the borders of the municipality, if the resident does not like the management or rates, he can vote the governing body out of office and thus achieve reform. On the other hand, if the rates are high and the

operation is profitable, the excess revenue would pass to the municipal treasury and benefit the taxpayer. In this situation, he would not be likely to complain or vote the governing body out of office just to aid the foreign consumer in an adjoining municipality. Thus, from a practical standpoint, if the Public Utilities Commission has no jurisdiction, the foreign customer must undertake a difficult burden of challenging the rates in court. (See In re Morris Townships Complaint (1967) 49 N.J. 194 (229 A.2d 516, 521.)

Occasionally, a public utility commission will approve uniform water rates both within and outside corporate limits. (E.g., Manufacturers Ass'n of Erie v. Pa. Public Utility Commission (1979) 47 Pa.C31 (407 A.2d 114.)[39]

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[39]Where water is furnished by a private company from the same sources, and is supplied to separate counties and

However, the fact that a public utilities commission is regulating rates, does not necessarily eliminate all discrimination. To illustrate, in Borough of Ambridge v. Pennsylvania Public Service Utility Commission, supra, 137 Pa. Super. 50 (8 A.2d 429), the court acknowledged that the municipality could make a profit from service to outsiders and that the citizens and taxpayers should not be asked to bear any part of the additional expense in supplying water to customers outside the city. The court said: ". . . A municipality may

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communities, and there are no elements creating a material difference in cost, a uniform rate is indicated. (New Haven v. New Haven Water Co. (1934) 118 Conn. 412 (172 A. 767, 776-777).)Also, generally speaking, the courts will not permit discrimination by a private water company in favor of certain customers, or allow it to set exorbitantly high rates for others. (Griffin v. Goldsboro Water Co. (1898) 122 N.C. 206 (30 S.E. 319, 320.)

discriminate between its customers within its limits and those without; that while it is entitled to change rates that will return a fair profit based on the present value of all its property used and useful in the public service, it may forego such profit as respects its customers within its limits and demand it of its customers outside its limits; that in arriving at the fair value of its property for the purpose of fixing just and reasonable rates to its customers within the city, the value of the property outside the city of borough must be segregated and deducted from the value of the entire plant, and the value of the property within the city thus be ascertained in fixing the fair and reasonable rates to be charged for water within city limits; and that the rates to be charged customers outside the city must cover a fair

return on the property thus devoted to the public service outside city limits plus a fair proportion of the value, cost and expense of the plant within the city and that no part of the burden of furnishing water to customers outside the city can properly be placed on its citizens and customers within city limits." (8 A.2d 429, 433.)

A Wisconsin court has suggested that the margin of profit should not be merely sufficient to provide as fair and reasonable return as is considered proper for other public utilities, but should at all times be ample to inspire and facilitate the continued development and improvement of the plant, and the efficiency of the service, so that the quality and abundance of the supply will always be well in advance of the actual needs of the community. (Pabst Corp. v. Railroad Commission (1929) 199

Wis. 536 (227 N.W. 18, 20.)[40]

In Village of Fox Point v. Public Service commission (1943) 242 Wis. 97 (7 N.W.2d 571) the court considered a challenge to a rate charged by the City of Milwaukee which yielded a 4 percent rate of return. Pursuant to section

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[40]Conversely, although a Vermont court acknowledged that the resident taxpayers were entitled to some consideration for the risks assumed in undertaking the enterprise to which their credit was pledged, and that it would be unfair to require taxpayers who contributed the capital investment to pay a rate of return on the investment they alone contributed, a municipally owned utility should not impose unreasonably high rates to gain revenue for governmental operations. Hence, where the electrical department contributed 60 percent of the village's budget, the utilities commission could reduce the rate disparity. (Hastings v. Village of Stowe Electric Department (1965) 125 Vt. 227; 214 A.2d 56, 62.) Also, a municipal utility, having no stockholders, does not have to compete in the market for equity capital. Hence, where it had retained earnings of $812,000, it did not need even a 10 percent return, and has allowed a rate of return equal to twice its interest expense. (Village of Hardwick Electric Department (1983) 143 Vt. 437 (466 A.2d 1180).)

66.069 of Wisconsin statutes annotated, the city is entitled to the same rate of return as permitted by privately owned utilities. The city could either use revenues for construction or deposit them into a general fund to be used for general city purposes. Finally, the statute allowed the utility to charge for local and school tax equivalents. The court acknowledged that while a municipally owned utility was tax exempt, the statute authorized the city to include $550,000 as a tax equivalent in its operating expenses.

Under New Jersey law, water rates charged other municipalities are subject to the regulatory power of the Board of Public Utility Commissioners. (City of North Wildwood v. Board of Commissioners of Wildwood (1976) 72 N.J. 354 (365 A.2d 465).) The Public Utility Board also assumes jurisdiction if it serves more

than 1,000 nonresident customers. or the municipal water revenues from nonresidents exceed 25 percent of the total water revenue (N.J.S.A. 40: 66-85.2). Under this statute, it may recoup its costs of operation, including taxes and budget deficits for the previous year. However, if it is not subject to jurisdiction by the board, it must charge nonresidents the same rates.

Because the statute requires uniformity, actual costs need not be calculated. (Reahl v. Randolph TP. Mun. Utilities Authority (1978) 163 N.J. Super. 501 (395 A.2d 241, 249 (sewer service); see also Weidling v. Borough of Manville. supra, 172 N.J. Super. 371 (412 A.2d 133 (water rates).)

Florida allows a municipality to impose a 25 percent surcharge to water customers outside city limits. (Fla. Stats. sec. 180.191.) The Florida

Supreme Court has upheld this surcharge on the ground that as density increases and additional demand is created, additional costs are borne in terms of capital expenses and other costs which could not be pinpointed even under sophisticated cost accounting techniques. (Mohme v. City of Cocoa (Fla. 1976) 328 So.2d 422 425.) Although the statute allows up to an additional 25 percent surcharge, not to exceed a total surcharge of 50 percent, using the same factors used in fixing rates closed to other city residents, a triable issue of fact exists when it is alleged that the charges exceeding 25 percent are unjust and inequitable, (Mohme v. City of Cocoa, supra, 328 So.2d 422, 426;[41] compare Hunger v. City of Zephyrhills

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[41]Subsequently it was held that a class action could be maintained. (Mohme v. City of Cocoa (Fla.App. 1977) 356 So.2d 2.)

(Fla. 1975) 307 So.2d 487), where additional cost factors involved in serving nonresidents and capital outlay costs supported the 50 percent surcharge.

In Illinois, a statute (Smith Hurd Annot. Ill. Stats. c. 42, sec. 348) requires that water must be provided certain cities at no greater price than the sum the city of Chicago collected from customers within its own limits.Seventy-four suburban communities claimed that the uniform rate was discriminatory, and that the statute merely set a ceiling on the rates. They alleged that the consumption of water within the city was higher, yet 27 percent of the population in the suburbs using 18 percent of the water was charged 27 percent of the total costs. Also, it cost the city $7,000,000 to meter, deliver water to, and collect

revenue from its customers but this charge was allocated to the suburbs as well. Even though the suburbs maintained their own fire departments, the suburbs were paying for 46,000 hydrants in Chicago and the excess pumping capabilities needed by Chicago for its own fire protection. The Illinois court acknowledged that although the city could make a profit and create a surplus, the statute simply imposed a ceiling and a uniform rate does not establish that the rates were in fact nondiscriminatory. The judgment of dismissal was reversed. (Village of Niles v. City of Chicago (1980) 82 Ill.App.3d 60 (401 N.E.2d 1235. 1239-1240.)

In City of Plymouth v. City of Detroit (1983) 130 Mich. A. 155 (344 N.W.2d 291, 295) the court concluded that although by statute, the rate charged

nonresidents could not exceed twice the local rate, Detroit had agreed by contract to charge rates reasonable in relation to cost. See also Fairway Manor Inc. v. City of Akron (1983) 13 Ohio App.3d 233 (468 N.E.2d 927, 931-932) where the court found a rate surcharge of 12 percent was discriminatory on its face, requiring the city to show conditions which justified the rate differential.

When no specific statute or contract applies, nonresidents have had a very difficult time challenging surcharges or differential rates. For instance, a city has successfully defended a lawsuit by establishing that the system was financed by taxes. See e.g., Barr v. First Taxing District of the City of Norwalk (1963) 151 Conn. 53 (192 A.2d 872) (the income from revenue was insufficient to pay carrying charges on

bonds, requiring taxes. Outside growth required expansions of the system including a dam); (Louisville & Jefferson Co. Metropolitan Sewer District v. Joseph E. Seagram & Sons, supra, 307 Ky. 413 (211 S.W.2d 122, 126; 4 A.L.R. 2d 588); Wells v. City of Jackson (1955) 223 Miss. 228 (77 So.2d 925, 926-927; Ashley v. City of Gilmer (Tex.Civ.App. 1954) 271 S.W.2d 100.) (The revenue was insufficient to make all payments on revenue bonds and taxes had to be levied. Additional pumping and fuel cost, and meter reading expense, increased as the distance increased).

Even when the system was acquired with revenue bonds, and no tax revenue was employed, a rate differential has been upheld. See e.g.. Town of Terrell Hills v. City of San Antonio (Tex.Civ.App. 1958) 318 S.W.2d 85, 88. (A 29 percent

surcharge was justified because the cost of reading nonresident meters was substantially higher, their need for fire protection and standby water demand was higher, and the municipality, which bore the burdens and responsibilities of management, was entitled to a 7 percent return.); County of Oakland v. City of Detroit (1978) 81 Mich.App. 308 (265 A.2d 130, 132.) (A sewer rate 14 cents higher than the 75 cent charge within the city constituted a reasonable return on investment. While the financing costs were the same, the city provided police and fire protection, faces the risk of tort liability, and loses money from its tax base by providing facilities.)

A variety of reasons have been offered to justify a surcharge. (See e.g.. Deloney v. Rucker (1957) 227 Ark. 869 (302 S.W.2d 287, 289.)(City residents

have a preferred claim to the benefits of owning a waterworks and, absent a statute to the contrary, may discriminate in rates based upon a political boundary. Further, all evidence showed that it was in fact more expensive to serve the less densely populated suburbs.) (Clay Utility Co. v. City of Jacksonville (Fla.App. 1969) 227 A.2d 516, 518.) (It costs more to extend the high voltage lines over long distances to widely scattered customers.) (Usher v. City of Pittsburg (1966) 196 Kan. 86 (410 P.2d 419.) (A 100 percent increase was warranted in light of investment outside the city and an allocation of operating, maintenance and depreciation charges.) (City of Detroit v. City of Highland Park (1949) 326 Mich. 78 (39 N.W.2d 325, 334.) (Utility property is not taxed and other services are provided by the city, such

as police and fire protection. A 5.97 percent return was reasonable.) (Botkin v. City of Abilene (Tex.Civ.App. 1953) 262 S.W. 2d 732.) (Outside users resided as much as 18 miles away requiring meter readers to take twice as much time. Also the private system was purchased with general obligation bonds.); (Faxes v. City of Grandview (1955) 48 Wash.2d 342 (294 p.2d 402. 405-409.) (A 50 percent surcharge was justified because it cost more to read nonresident meters. Salaries, insurance premiums, and legal expenses, and other overhead expenses were paid out of general funds. Thus, proof that a differential exists does not amount to a prima facie showing that the nonresident rates are unreasonable. A city boundary line divides those who made a capital contribution and those who have not done so.) (Geneva Water Corp. v. City of Bremerton (1975) 12

Wash.A. 856 (532 P.2d 1156, 1161-1162.) (Even though it was impossible to isolate costs and benefits with precision, bulk water purchasers failed to meet its burden of showing that the city did not incur a higher cost serving them.)[42]

However, there have been several examples where discrimination against nonresident water users has not been countenanced. In City of Montgomery v. Greene (1913) 180 Ala. 322, 329-330 (60 So. 900, 902) the court ruled that once a municipality

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[42]It has been suggested that while the burden should remain on the party challenging the rate, the city should have a duty of compiling and producing cost data for each item used in calculating rates. If the city has acted properly, it should already have this information at hand. (4 Clark. Waters & Water Rights, (1970) sec. 349, p. 460.) Thus. a board has been enjoined from raising water rates where it refused to allow responsible persons to see its books and records. (Waterworks Board of Town of Parrish v. White (1967) 281 Ala. 357 (202 So.2d 721, 724.)

attempts to supply water beyond its corporate limits, it must be with uniformity and without discrimination. A different rate fixed wholly upon corporate lines as the line of demarcation, in the absence of physical differences, was an unreasonable classification.[43]

Likewise, in Hicks v. City of Monroe Utilities Commission (1959) 237 La. 848 (112 So.2d 635) the court ruled that when the city acquired a private water

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[43]However, in Waterworks Bd. of Birmingham v. Barnes (Ala. 1983) 448 So.2d 296, the court clarified its position and held that political boundaries could be used for rate zones where the zones themselves were based on a study which indicated that there were differences in the distance from the filter plant, differences in population density and land use, differences in the amount of water needed for fire fighting, and etc. The court emphasized that supplying water was not a tax. Even if tho groups were supplied from the same main, the physical differences between two sides of a political boundary may constitute a basis for classification based upon differing costs of service. (Id,. pp. 299-300.)

system, it was bound to continue to serve the customers of the system, at nondiscriminatory rates. It was therefore improper for a city to charge a nonresident who received electricity from a public utility at the rate of $10.50 for water alone when it charges its residents a $2.50 rate for water if the customer obtained both water and electricity from the city.[44] In Malvern v. Young (1943) 205 Ark. 886 (171 S.W.2d 470, 474) it appeared that when the city obtained a waterworks from district 12,

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[44]See also Town of Taylorsville v. Modern Cleaners (1977) 34 N.C. App. 146 (237 S.E.2d 484). Likewise, it was unreasonable to change mobile home parks at the rate of $8.50 per month for unsewered facilities, which was twice the rate for sewered facilities, on the basis that the district had to install a collection system, when in fact the owner installed a sewer system and connected it to the district interceptor. (Daltonn v. South Fork of the Coeur D'Alene River Sewer District. (1980) 101 Idaho 833 (623 P.2d 141.)

district 12 had allowed residents of districts 14 and 16 to receive water at the same rates charged residents in district 12. Without any change in conditions or additional expenditures, the city now proposed to impose a surcharge upon residents in districts 14 and 16. The court concluded that this was an unreasonable discrimination. It suggested, by way of dictum, that the city could classify customers on the basis of distance or expense of delivery, noting that conditions may be different if the consumers lived in a sparsely settled area.

In City of Texarkana v. Wiggins (1952) 151 Tex. 100 (246 S.W.2d 622), the city bought a private water system and financed the acquisition with revenue bonds. It then exacted a 50 percent surcharge upon nonresident water consumers. The court ruled that when

the City of Texarkana purchased a privately owned utility, it was subject to the same rule prohibiting unreasonable or unjustified discrimination in rates and charges imposed upon privately owned utilities. The court said: "The change from private to public ownership may, in theory at least, eliminate or lessen the profit motive, but the customer of utility services still cannot pick and choose his supplier of water as he does his grocer. The utility customer is thus at the mercy of the monopoly and, for this reason utilities, regardless of the character of their ownership should be, and have been, subject to control under the common law rule forbidding unreasonable discrimination." (246 S.W. 622, 625.)

The court held that a governmental unit having the power to withhold a

privilege did not perforce have the lesser power of offering it on whatever terms it can impose. Once it elected to serve, it must do so on a nondiscriminatory basis. Here, the only difference was whether the customer resided north or south of 29th Street. The court held: "The limits of a municipal corporation, of themselves, do not furnish a reasonable basis for rate differentiation." (246 S.W. 622, 626.)[45]

In Inland Real Estate v. Village of Palatine (1982) 107 Ill.App.3d 279 437 N.E.2d 883), the defendant had acquired a private water company in an

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[45]Apparently, the rule in the Wiggins case only applies if the rate differential is promptly challenged. Thus, when, for 31 years, the surcharge has never been less than 10 percent and at one time amounted to 100 percent, a challenge to a new 30 percent surcharge will be barred. (Town of Terrell Hills v. City of San Antonio (Tex.Civ.App. 1958) 318 S.W.2d 85, 87.) The rationale of the Texas court is far from clear.

unincorporated area, and then not only raised the rates above those previously approved for the private water company by the public utilities commission, it charged a rate to nonresidents which was higher than that charged to village residents. Although the court acknowledged that the municipal rates were exempted under the Public Utilities Act, the aggrieved parties had a remedy: ". . [I]inability of the consumer to vote municipal officials in or out of office does not leave the customer without a remedy, because the reasonableness of rates is subject to judicial review. . . ." Municipal officers under the Municipal Ownership Act cannot discriminate in rates or make exorbitant and unjust rates to consumers if they discharge their duties faithfully, honestly, and efficiently under the Act. . . ." (437 N.E.2d 883,

886.)

Austin View Civic Association v. City of Palos Heights, supra, 85 Ill.App.3d 89 (405 N.E.2d 1256), which is discussed in the text of the opinion, involves virtually the same scenario.

Finally, mention should be made of City of Palo Alto v. City and County of San Francisco (9th Cir. 1977) 548 F.2d 1374. In that case, after the San Francisco fire, the City and County of San Francisco were granted the right to build a dam and reservoir to the Hetch Hetchy Valley in Yosemite National Park. However, as water would be supplied to other communities, the enabling legislation enacted by Congress, the Raker Act of December 19, 1913, (38 Stat. 242), prohibited San Francisco from discriminating other than on the basis of cost. San Francisco decided to raise the water rates to other cities by

20.5 percent while raising the rates to its own inhabitants by 14.5 percent. The Ninth Circuit held that the statute conferred standing upon the adjacent cities and upheld a preliminary injunction enjoining the rate increase.

2. A CRITIQUE

To summarize, although discrimination has been banned by a few statutes, in most jurisdictions, courts have left nonresidents at the mercy of the municipal water monopoly. As we have seen, on the theory that a municipality is entitled to a profit, courts have upheld rates which allow a city to siphon over a million dollars from increased water and sewer revenues into its general fund (Apodaca v. Wilson (1974) 86 N.M. 516 (525 P.2d 876), and allowed it to obtain 23 percent and 30 percent of its budget requirements from its utility systems. (San Antonio

Independent School Dist. v. City of San Antonio (Tex. 1976) 550 S.W.2d 262, 264-265; cf., Rosaland Holding Co. v. Orlando Utilities Commission (Fla.App. 1981) 402 So.2d 1209, 1213. fn. 19.) Of course, once you accept the premise that a city is entitled to forgo any rate of return upon service to enfranchised voters within city limits, and to collect the profits exclusively from those denied the right to participate in the political process, then discrimination becomes a foregone conclusion.[46]

Note also that private utilities, entitled to a profit, are not allowed to discriminate, and, in most states, are

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[46]Although this is not a voting rights case, this practice illustrates the potential economic impact of Gomillion v. Lightfoot (1960) 364 U.S. 339, which prohibited a city from redrawing its boundaries for the purpose of political and racial discrimination.

not allowed to increase the rates paid by customers living outside city boundaries to pay the Franchise, Business and Occupation taxes imposed upon the utility by local municipalities. Yet, a municipal owned utility is allowed to create preferential rates, based upon political boundaries, and impose taxes upon nonresidents, to the end that theirconstituents can profit from the resulting discrimination. In essence, most courts, and a few legislatures, have created a double standard, by allowing a municipality to discriminate in the sale of water, the essence of life itself.

Sadly, when confronted with discrimination, some courts simply refuse to require the municipality to justify why a surcharge is always necessary.(Mohme v. City of Cocoa,

supra, 328 So.2d 422, 425; see also Geneva Water Corp. v. city of Bremerton, supra. 12 Wash.App. 856 (532 P.2d 1156, 1161-1162.) Other courts fail to appreciate the fact that although new service to distant customers may be more costly, (Clay Utility Co. v. City of Jacksonville, supra, 227 So.2d 516, 518; Botkin v. City of Abilene, supra, 262 S.W.2d 732), that fact would hardly justify imposing the same rate surcharge upon other consumers in densely populated suburban areas near the city itself, especially those who obtained service years before. While it is obvious that if the utility is not self-supporting, and must take recourse to taxes, the outsiders should not enjoy a free ride, some attention should be given to the taxes actually levied. Otherwise, the reader could easily visualize a situation where a city could

impose a modest tax levy upon its residents and then use this as a pretext for rate discrimination against nonresidents in perpetuity.

CERTIFIED FOR PUBLICATION IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION SIX

COURT OF APPEAL-SECOND DIST.
FILED
MAY 7 - 1985
CLAY ROBBINS, JR. Clerk

2d Civil No. 67886
(Super. Ct. No. 55769)
(Ventura County)

OPINION ON DENIAL OF REHEARINGS AND MODIFICATION OF OPINION

MAGDALINE M. HANSEN, et aI,

Plaintiffs and Appellants.

v.

CITY OF SAN BUENAVENTURA

Defendant and Respondent.

THE COURT:

Only a few of the points raised in the petitions for rehearing deserve answers.

1. Appellants urge that rate base valuation is no longer relevant because this court disallowed the practice of charging nonresidents with a rate of return. However, it is elementary that assets must be subject to depreciation. (Knoxville v. Knoxville Water Co. (1908) 212 U.S. 1, 13-14; Contra Costa Water Co. v. Oakland, Etc. (1911) 159 Cal. 323, 335; Miller v. Railroad Commission (1937) 9 Cal.2d 190, 201.) Therefore, it was necessary to consider whether particular assets could be depreciated. Appellants, still captivated by their equal protection theory, suggest that we overlooked the central issue in this lawsuit, namely, the discriminatory animus of the city. Once a discriminatory design exists, appellants evidently believe that no surcharge is permissible. To the contrary, our task is to simply review the result of the

city's action. "The function of the courts is merely to ascertain whether the power has been carried out beyond the constitutional limits so fixed; and, if such be found to be the case, to declare the acts of the council void. They do not sit as appellate tribunals to review the correctness of the council's determination, nor need they know anything about the evidence on which that body has acted. All that they have to consider is, whether, in a given case, the result of the council's action will be to take the property of the complaining party without just compensation. . . ." (San Diego Water Co. v. San Diego (1897) 118 Cal. 556, 564-565; see also Durant v. City of Beverly Hills (1940) 39 Cal.App.2d 133, 139.)

3. Appellants suggest that nonresidents should not pay any part of

the cost of borrowed servants. We disagree. The opinion clearly holds that to the extent to which city devotes any tax revenue to pay the salaries of employees of the waterworks, or to otherwise improve the system (other than by way of a loan which is to be repaid), then some reasonable surcharge is appropriate so as to prevent nonresidents from being unjustly enriched. Until the trial court makes those calculations, neither side can claim glory.

4. The city tells us that we should be bound by the experts who believed that Ventura was entitled to a reasonable rate of return. However, experts may not testify on questions of the law of this state. Such testimony, and the trial court's findings based on that testimony, are not binding on this court. (Communications Satellite Corp.

v. Franchise Tax Board (1984) 156 Cal.App.3d 726, 747; Standard Register Co. v. Franchise Tax Board (1968) 259 Cal.App.2d 125, 129-130.) In our opinion, we carefully examined the validity of each theory advanced by the experts. We accepted some of those theories, and rejected others, as being contrary to California law. Therefore, when the case is retried, or a similar dispute comes before a court, the trial judge will not be confused by experts who attempt to interpret what the law should be as they recite the custom and practice in the industry. (See Elder v. Pacific Tel. & Tel. Co. (1977) 66 Cal.App.3d 650, 664.)

5. We are told that we assumed, without any support in the record, that a large portion, if not a majority, of those living outside city limits are not within the boundaries of the Casitas

Municipal Water District. However, the boundaries of the city and the district are depicted on a map included in the record on appeal, even if it does not shed light on the population distribution.

6. The city also claims that it had the right to treat oil companies as a separate class of customers.
We do not quarrel with that decision. What we do find to be unfair is to totally eliminate a profit center. You do not have to have a PHD in economics from Harvard to understand what happens when you eliminate a source of profit from your books of account.

7. We are not impressed by counsels attempt to distinguish between a rate of return and a profit. The terms are synonymous. (Sun Valley Water Co. v. Arizona Corporation Com'n. (1976) 26 Ariz.App. 304 (547 P.2d 1104, 1109,

vacated on other grounds in Sun City Water Co. v. Arizona Corporation Com'n. (1976) 113 Ariz. 464 (556 P.2d 1126; see also Gen. Tel. Co. of Calif. (1980) 4 Cal. P.U.C.2d 428, 438 (37 PUR (4th ed.) 127, 135-136).) As the late Senator Sam Ervin once said: "Ostriches stick their heads in the sand to conceal reality from themselves. Politicians employ euphemistic words to hide realty from the people."

The opinion in chief is modified in the following regards:

1. On page 5, line 6, delete the numbers "1500" and in lieu thereof insert "1000."

2. On page 29, on the last line of footnote 6 delete the numbers "3345" and in lieu thereof insert "313" so that the citation will read "Cal.P.U.C. 313, 321."

3. On page 37, line 2 of the last full paragraph delete the word "for" and in lieu thereof insert "from."

4. On page 37, at the end of line 3 of the last full paragraph delete the number "4" and in lieu thereof insert a dollar sign "$."

5. On page 38, line 2 of heading 4, delete the words "THE UTILITY" and in lieu thereof insert "IT."

6. On page 38, line 5 of heading 4, delete the word "DISCRIMINATORY" and in lieu thereof insert the word "WATER."

7. On page 49, line 2 change the word "unequitable" to "inequitable" and insert between the words "the" and "Consumers" the words "customers of."

8. On page 49, line 3 insert after the word
"integrated" the words "Pan Handle-Trunkline."

9. On page 54, line 6 of footnote 11,

delete the words "most of whom also" and in lieu thereof insert "especially if the latter."

10. On page 59, line 4 from the bottom o# the page delete the numbers "1978" and insert "178."

11. On paqe 59, line 2 from the bottom of the page insert the numbers "12" after 285 N.W. 2d.

12. On page 70, line 2 of the second full paragraph the word "nonresident" should read "nonresidents."

13. On page 72, the word "Randon" appearing on the last line of footnote 19, should read "Random."

SUPERIOR COURT OF CALIFORNIA

COUNTY OF VENTURA
NO. 55769

FINDINGS OF FACT AND CONCLUSIONS OF LAW

FILED
AUG 17, 1981
ROBERT L. HAMM, County Clerk

MAGDALINE M. HANSEN, individually and on behalf of all those similarly situated,

Plaintiff,

vs.

THE CITY OF SAN BUENAVENTURA,

Defendant.

PROCEDURE

1. This complex litigation arises out of a complaint filed on June 8, 1973, by the original plaintiffs Lawrence Storch and Susan C. Storch, individually and on behalf of a class of persons similarly situated, against the City of San Buenaventura, wherein the plaintiffs

seek declaratory relief to determine the validity of Ordinance No. 1727, originally enacted by defendant City on May 15, 1972.

2. Specifically, the plaintiffs assert that an actual controversy has arisen and exists between plaintiffs and defendant relative to the water rates established by said ordinance insofar as it applies to plaintiffs and particularly assert that the water rates so established by the ordinance are exorbitant, unconscionable, unreasonable, arbitrary and discriminatory and do not bear any relationship to the actual cost of furnishing water to plaintiffs. Accordingly, insofar as the ordinance applies to plaintiffs, it was alleged the same violates the due process and equal protection clauses of the United States and California constitutions and

the laws of the State of California.

3. In addition, plaintiffs seek damages in a sum representing the difference (70%) charged water customers residing outside of the city limits of the defendant City in excess of the sum paid by residents of the City of San Buenaventura for water service.

4. On July 23, 1973, the defendant City filed its answer, generally denying that the matter was a proper class action; further that the failure to comply with Section 945.4 of the Government Code respecting the filing of a written claim, effectively barred plaintiffs' complaint, and a general demurrer on the grounds that the complaint failed to state a cause of action.

5. On December 6, 1973, the parties entered into a written stipulation, agreeing that the plaintiffs are deemed

to have complied with Section 945.4 of the Government Code, that plaintiffs' claim for damages was deemed to have been duly and properly denied, and stipulating that the defendant's answer with respect to failure to file a claim would be deemed stricken. Further, the parties stipulated that breadth of plaintiffs' complaint, and claim, would be based solely upon the water rates that were authorized and put into effect under the provisions of the defendant's Ordinance No. 1727 and that plaintiffs would not and could not seek to recover any claim for damages or refunds with respect to water rates existing or enacted prior to Ordinance No. 1727.

6. In this posture, the litigation lay dormant for almost three years until August 9, 1976, when a memorandum that the case was at issue was filed by the plaintiffs. Thereafter, the case was

set for trial.

7. On May 19, 1977, the plaintiff Magdaline M. Hansen was substituted for the initially named plaintiffs and a motion to certify the class was filed, accompanied by a Declaration of the named plaintiff, Magdaline M. Hansen, which Declaration challenged the seventy (70%) percent surcharge imposed upon all water customers of the City of San Buenaventura who are located outside the City's boundaries; the Declaration further stated:

> "This class action seeks to determine the validity of defendant's seventy (70%) percent surcharge and to recover damages in the amount of the surcharge from July 1, 1972, up to and including the time of trial."

8. On June 6, 1977, a Stipulation and Order was signed, wherein the complaint was amended expanding the members of the class. Said Stipulation and Order further provided that as to members of the class not owning real property, the

defendant raised as affirmative defenses the failure to file a claim, failure to comply with Section 945.4 of the Government Code, and the Statute of Limitations.

9. Further, on June 6, 1977, the court determined that the nature of the case was appropriate for a class action and directed that notice of mailing of the pendency of the class action would be given by the plaintiff and that publication be made in the local newspapers.

10. The Notice, which was approved by the Court, stated that plaintiff seeks to declare invalid defendant's ordinances which, as of July 1, 1972, imposed a seventy (70%) percent surcharge upon all water customers of defendant located outside the defendant City's boundaries; it further stated plaintiffs' action, therefore, requests

declaratory relief to determine that water customers outside the City's boundaries should be charged the same rates as those located inside the City, and also requests damages in the amount of the surcharge from July 1, 1972, to and including the time of trial.

11. Although some disclaimers were filed by outside water customers, there was no dispute that at the time of the trial the number of "outside" water customers approximated 2,800.

12. In order to facilitate the trial of the case, the parties agreed that pending the resolution of the main action for declaratory relief and the various constitutional issues involved, all claims for damages, and thelegal and factual defenses thereto, would be bifurcated, to be determined if necessary, after the resolution of the primary action.

FACTS

A.

PURCHASE OF SYSTEM AND GENERAL BOND FINANCING

13. Prior to 1923, the City of San Buenaventura and adjacent territory was provided water by the Southern California Edison Company.

14. Upon application in 1921, a hearing was conducted before the then California Railroad Commission, the predecessor of the Public Utilities Commission, wherein the Southern California Edison Company, a public utility corporation, sought an increase in rate charges in order to yield sufficient revenue to pay the expenses of operating the water system for domestic, industrial, irrigation, and municipal purposes in the City of San Buenaventura and adjacent territory.

15. The Railroad Commission

authorized annual charges for the area serviced by Southern California Edison Company to produce an eight (8%) percent return upon an original estimated cost of all of the utility property and a six (6%) percent replacement annuity charge on that cost basis, utilizing a sinking fund method, and in addition authorized a fixed sum for maintenance and operation.

16. There were in fact rate differentials in effect with domestic users being supplied at a flat rate and irrigation rates at $0.25 per miner inch.

17. Southern California Edison Company provided irrigation water to certain users located outside the city limits.

18. In 1923, the City of San Buenaventura purchased the facilities of Southern California Edison Company that

were being used to provide water service to the City and surrounding area.

19. As part of the acquisition by the City, the City also assumed responsibility for providing the irrigation services previously provided by Southern California Edison Company.

20. The purchase and improvement of the water system were financed through the issuance of general obligation bonds in the sum of $250,000.

21. Before the purchase, the issuance of these bonds was authorized in an election by the qualified voters of the City.

22. Subsequently, the City of San Buenaventura caused to be issued general obligation bonds in the years 1925, 1927, 1948 and 1960, in the respective amounts of $35,000, $325,000, $1.500,000 and $1,750,000, the proceeds of which were used to finance, build up, enlarge,

improve and modernize the Ventura Water System.

23. All of the general bond issues described above were approved at elections by the qualified voters of the City, and were general obligations and a direct liability of the whole City; as a result of the general bond issues, all private property within the city limits became subject to a lien securing payment of the bonds; the bondholders had the right to require the City, if funds were not otherwise on hand, to levy taxes sufficient to pay such bonded indebtedness.

B.

OUTSIDE RATES

24. Since March 1, 1935, the City has maintained a differential in water rate schedules, and since that time out-of-city customers have been required to pay

higher rates than in-city customers.

25. In 1935, the City enacted a forty-eight (48%) percent differential in charges to its non-resident customers.

26. A study of said differential in rates was conducted by the California Railroad Commission in the early 1940's and said study sustained the reasonableness of the outside domestic rates then in effect.

27. In its study, the Railroad Commission did not use its standard practice or method applicable to investor owned utilities, but rather utilized the well recognized "utility" method of reviewing the rates; this method was also utilized by the City in the 1970s to ascertain the results of the differential enacted in 1972, as further described in later Findings, which deal with the methodology used in

that review.

28. The utility method of reviewing the rates which are the subject of these proceedings and the manner in which the Railroad Commission and the City experts utilized this method demonstrates that the rates charged the plaintiffs are lower than those which can be reasonably justified.

C.

PURCHASE BY CITY OF MOUND WATER AND SATICOY WATER COMPANIES

29. In 1966, the defendant City of San Buenaventura purchased the Mound Water Company (Mound), including all its water rights, for the total sum of $62,500.

30. Pursuant to the terms of the purchase agreement for the Mound System, the City agreed to furnish water "to those customers heretofore served by Mound who may desire such service at the

regularly established rates for water service from the Ventura Water System."

31. The water supplied by the Mound Water Company came from wells and was of poor quality, exceeding 1,200-1,500 parts per million of total dissolved solids.

32. Upon acquisition by the City, these wells were abandoned, and the City commenced supplying the former customers of Mound with water of substantially better quality.

33. The City acted properly in taking said wells out of service.

34. Mound was a mutual water company which represented to the City in the agreement of sale that the sale had received the approval of Mound's shareholders, since such approval was required by the California Corporation Code.

35. This consensual sale by the

shareholders of the Mound Water Company of its water supply and distribution system was the product of an arms-length transaction.

36. The sale of Mound to the City immediately improved the quality, availability, and overall source of supply and service to the area previously served by Mound well beyond that provided by the Mound Water Company.

37. Mound Water Company could have rejected the willingness and offer of the City of San Buenaventura to purchase the Mound Water System.

38. Nothing in the Mound Water Company-City of San Buenaventura sale precluded the City of San Buenaventura from continuing to apply water-rate price differentials between residents of the City and non-residents; the sales transaction simply provided that the

customers served by Mound at the time of the sale would be provided service by the City at regularly established rates for water service from the Ventura Water System.

39. In 1969, the City of San Buenaventura purchased the Saticoy Water Company (Saticoy), including all of its water rights, for approximately $2,000,000.

40. Saticoy had been serving customers within the City and outside the City.

41. After the purchase of the Saticoy and Mound Water Companies, there were approximately 2,800 outside water users served by the Ventura Water System.

42. The vast majority of outside customers came as part of the Mound and Saticoy purchases; these former shareholders and their successors in interest are the principal beneficiaries

of plantiffs' class.

43. Prior to the purchase of the Saticoy and Mound water companies by the City, the vast majority of plaintiffs were paying a different price for their water than City customers even though City consumers and plaintiffs may have been neighbors living across the street from one another.

44. Saticoy was an investor-owned public utility, whose owners, by agreement approved by the California Public Utilities Commission, sold the Saticoy Water Company to the City.

45. The customers of Saticoy had the opportunity to appear before the Public Utilities Commission, but the opinion of the P.U.C. approving the sale does not indicate that any protests were in fact received.

46. By the terms of the agreement and the Commission's approval, the old rates

were to remain applicable for sixty (60) days but the City reserved the right to alter said rates at any time subsequent to the expiration of said 60-day period.

47. Sixty (60%) percent of the customers of the Saticoy Water Company were residents of the City of San Buenaventura, and they were provided the opportunity to participate in an election, in which voters overwhelmingly (89%) gave approval to the purchase of the Saticoy Water Company by the City of San Buenaventura.

48. At the time of the sale, the Saticoy Water Company had only four small storage tanks, whereas after the sale the water users located in the former boundaries of the Saticoy Water Company had available over 50 million gallons of storage from numerous tanks and reservoirs tied into the Ventura Water System.

49. The Saticoy Water Company had two small wells; one of these wells was immediately abandoned by the City because of poor quality (over 1,500 parts per million of total dissolved solids) and the other well was placed on an emergency standby status and is rarely used because of its poor quality.

50. The City acted properly in taking these wells out of service.

51. The former water sources of Mound and Saticoy did not meet State Department of Health standards with respect to water quality concerning total dissolved solids.

52. These standards recommend use of water containing not more than 500 parts per million of total dissolved solids, but permit 1,000 parts per million, and allow the use of water containing over 1,000 parts per million only under exceptional circumstances when other

sources of supply are not available.

53. After the purchase of Mound and Saticoy, Health Department standards required the City to provide alternate sources of water supply for the former customers of these two companies.

54. After the purchase of Mound and Saticoy, the City did in fact find alternate sources of water supply for the former customers of these two companies.

55. The City did not acquire surplus water as a result of the acquisition of Mound and Saticoy.

56. Water supplies from the City's own water rights were being fully used at the time of the acquisition of Mound and Saticoy, and the City was obligated to purchase from Casitas Municipal Water District ("Casitas"), and others, water necessary to replace the Mound and Saticoy water sources to serve the

former customers of these companies.

57. The cost of this additional water was substantially greater than the cost of the City owned water sources.

58. Had Casitas water or other water which met Health Department standards been available to Mound and Saticoy prior to the purchase Of these systems by the City, those companies would have been required to utilize such supplies at costs considerably greater than their own well supplies.

59. Water purchased by the City from Alta Mutual cost $35.00 an acre foot in 1970 and increased to $56.00 an acre foot in 1978. Water purchased by the City from Casitas in 1970 cost $44.00 an acre foot and increased to $61.00 an acre foot in 1978.

60. The cost of well water for the City as of the trial date was approximately $20.00 to $25.00.

61. The cost of the Ventura River water from the Foster Park Facility owned by the City is minimal.

62. By virtue of having its own water sources rather than having to purchase water, the City saves $30.00 to $40.00 for each acre foot of water.

63. As the cost of alternative sources of water has increased, and continues to increase, the value of the City's water rights has increased.

64. The City's Ventura River water rights are quantified at a minimum of 6,000 acre feet annually and the City's current groundwater rights are approximately 4,000 acre feet annually.

65. The value of the City's water rights were conservatively set at $5,000,000.

66. Nowhere in the language of either sales agreement was there anything to indicate that there would not continue

to be a surcharge to those Mound and Saticoy customers who resided outside the City.

67. The facilities purchased by the City of San Buenaventura from Mound and Saticoy water companies were insufficient, inadequate and deficient to meet the past, present and future needs of the customers previously served by the Mound and Saticoy water companies, all of whom are now served by the City of San Buenaventura.

68. The immediate benefits received by the Mound and Saticoy customers when they connected to the City system included better quality water, better reliability because of the City's additional sources of water supply and greater storage facilities, and better fire protection.

69. Longer range benefits received by the Mound and Saticoy customers included

the advantages of municipal financing, economies derived from the City's large-scale operation, the benefit of the City's entitlement to water from the State Water Project, and the 330 Zone improvements being constructed by the City.

70. The former customers of Mound and Saticoy received, and continue to receive, City water from sources and facilities for which they have not paid a proportionate share of the total expenses, both prior to the adoption of the ordinance in question and since; they also received the benefits of a system that gives them much better service.

71. The customers of the Saticoy and Mound Water Companies were absorbed into the Ventura Water System and immediately received the benefits of better service.

72. Due to the initiative and

willingness of the City to undertake the risks and burdens involved, said plaintiffs now have available for their benefit access to water from the State Water Project.

73. Some of the improvements which immediately became available to the Saticoy and Mound customers upon their obtaining service from the City included:

(a) Water for domestic consumption in the City of San Buenaventura is processed through two plants which provide complete treatment. A third plant at the municipal golf course partially treats well water produced at that location.

(b) The system transports the water through a 325-mile network of mains ranging in size up to 36 inches.

(c) The high quality of water service throughout the City is

reflected in the fact that the City of San Buenaventura is one of the 35 cities in the United States to have a Class 3 fire rating.

(d) The existing municipal water system contains a total of 58,598,751 gallons of storage capacity. The total available storage for domestic water is 57,198,334 gallons.

(e) The Ventura Water System has several sources of water supply, including.the Foster Park facility which is City owned, the Casitas Lake facility and Alta Mutual Water Company from which the City purchases water, and groundwater from City-owned wells in the Mound Basin, the Santa Paula Basin, and Montalvo Basin.

74. Major improvements planned for and made during the 1970's to the Ventura Water System benefited plaintiffs. These included the Avenue Treatment

Plant, which was doubled in size and line, an 8-mile pipeline, a five points pump station, a 2.5 million gallon storage tank at Sexton Canyon, $800,000 of water lines, a $1.000,000 contract in progress for new lines, and a $2.6 million contract underway for 4,000,000 gallons of storage.

D.

RATES SOUGHT TO BE DECLARED UNLAWFUL

75. Because of the impact upon the Ventura Water System caused by the acquisition of the large number of new customers then a part of the Saticoy Water Company, both residing within and outside of the City of San Buenaventura city limits, a review of the rate structure was undertaken by the City shortly after the acquisition of said company.

76. The firm of Wilsey and Ham was retained in 1970 by the City of San

Buenaventura to analyze the water rates, including as a small part of their study the differential between inside and outside City water customers; thereafter a twenty (20%) percent overall rate increase was adopted in 1970.

77. In 1972, upon obtaining up-dated figures, recommendations were made to the Ventura City Council, resulting in another ten (10%) percent overall water increase and the seventy (70%) percent surcharge rate to outside customers which the plaintiffs now challenge.

78. Mr. Heidrick produced the Wilsey and Ham Report and concluded that a surcharge of at least seventy (70%) percent on outside potable water customers would be justified, based upon a very conservative rate of return.

79. Subsequent water rates studies, including those by William Ferry of Brown & Caldwell, were utilized by the

City, to continue the existing seventy (70%) percent surcharge on out-of-city water customers.

E.

OUTSIDE USERS CONSTITUTED A SEPARATE CLASS OF CUSTOMERS AND THEIR RATES WERE PROPER

80. The City Council of the City of San Buenaventura is the lawful rate-making body for determining rates and classifications for the entire Ventura Water System dealing with both inside and outside water consumers.

81. As such a rate-making agency, the City Council is not only presumed to perform its official duty in a fair and impartial manner, but likewise is conferred some reasonable degree of discretion with respect to the evaluation of the various rate-making cost factors as applied to various classifications of water customers, both inside and outside the City.

82. The court totally rejects the plantiffs' contention that the City Council of the City of San Buenaventura has deliberately sought to impose or enact an unjust water rate, or arbitrarily and unjustly sought to classify its various water consumers within the Ventura Water System in an arbitrary or capricious manner.

83. The rates set by the City Council and charged to plaintiffs are based upon cost-related factors and are in fact fair, reasonable and lawful.

84. The plaintiffs have failed to establish that the rates so fixed are unreasonable, unfair or unlawful.

85. The City Council of the City of San Buenaventura, as the rate-making body for the Ventura Water System, has fully and thoroughly performed its trust both with respect to the fixing of the various classifications of water users

inside and outside the city limits, and further has fixed water rates for such classes of customers which do not unfairly or unreasonably discriminate between such classes.

86. Standing alone, the rates charged to plaintiffs are also fair, not excessive, and are justified by the cost of service.

87. The classification of customers, the differential between inside and outside rates, and outside rates established and paid within the period of time covered by this action were and have been reasonable, and were commensurate with the cost of service and services received, for the following reasons, among others: the costs of providing service to the outside users were greater; a return on the value of City property devoted to service of the outside customers is a proper cost of

service; the costs of service justify the rate differential and the rates charged to plaintiffs; the outside customers have not and do not make the same financial contributions to the maintenance of the City's Water System as those customers within the City; the outside customers do not have the same obligations and responsibilities for the replacement and repair of the water system in the event of disaster, or to provide for its expansion to meet population growth; the property of outside customers, unlike that of in-city customers, is not subject to any tax liability for bonds; nor do the outside customers have any risk or financial responsibility for payment of the City's contractual obligations under the State Water Projects; the outside customers acquired in the Mound and Saticoy transactions used up surplus

capacity which had been previously provided by the City in its water system without making any capital contribution therefor; the City was required to purchase higher cost water to supply the former Mound and Saticoy customers; without the cost differential imposed, the outside customers would have imposed substantial added costs and obligations upon the City and the in-City customers; the City substantially improved the water service provided to the former Mound and Saticoy customers, and such improved service fully justified the rates charged; such improvements included greater reliability, improved water quality, upgraded fire protection, and lower costs resulting from the benefits of municipal financing and the economies of large scale operations; the City has and continues to use general funds and its credit to support its

water system; acreage and connection fees which raise funds for the water system are charged to in-City residents only; tax rebates from the United Water Conservation District which apply only to in-City property; and for the reasons set forth in Paragraphs 92 through 99.

88. The classification of water customers established by the rate-making body, the City Council of the City of San Buenaventura, in fact, recognized that there was a legitimate difference based upon reasonable grounds to support the creation of the classifications of outside City water users and inside City water users, which classifications in fact have a fair and substantial relation to the object of the legislation.

89. Inside water customers and outside water customers, though all located within the Ventura water service

area, are different classes of customers and are not persons similarly situated; thus, they are not entitled to the same rates.

90. The out-of-city customers of the Ventura Water System are not essentially in the same or similar circumstances with regard to the water system as are in-city customers.

91. The criterion used by the City of San Buenaventura to create the classifications of inside and outside water customers is not based on plaintiffs' asserted contention that the division is simply an artificial political boundary line which has no relation to the water system.

92. Some of the factors which clearly support the City Council's action in establishing the out-of-city customers as a separate class of customers

subject to different and higher rates than those set for in-city customers include the following:

(a) The credit of the City residents was utilized to purchase and modernize the Ventura Water System, by voting to have their property subject to the liens of general obligations bonds, which funds were used to build up and maintain the improvements within the entire water system.

(b) To the extent that such general obligation bonds utilized the City's bonding capacity for the benefit of the water system, the same impaired the bonding capacity of the City by reducing the City's ability to pass other general obligation bond issues for other City purposes, which bonding capacity could have been used solely for in-city improvements.

(c) The fact that the City of San

Buenaventura, acting through its residents, has in fact made long-term contractual commitments with the State of California for water from the State Water Project to meet additional future anticipated water needs.

(d) No evidence whatsoever was produced by the plaintiffs to establish that any portion of the Ventura Water System revenue was being diverted to or being utilized for any other municipal activities; to the contrary, the total water revenue produced is returned to and is in fact utilized by the Ventura Water System in improving and maintaining the system for both inside and outside water customers.

(e) Revenue from other in-city sources is in fact utilized for the benefit of the Ventura Water System.

(f) General fund monies of the City of San Buenaventura are utilized to

provide space for 41 Ventura Water System employees who work totally within the water system; such general fund monies are also used to pay employees and to provide space for numerous other employees of the City who render indirect services to the water system in their official capacities and by their activities in operating the City's wholly owned water system.

(g) Only the City, as the owner of the Ventura Water System, would be directly responsible and, for that matter, has the financial capacity to either borrow funds, issue general obligation and revenue bonds for the repair of any catastrophic damage to the water system caused by an earthquake or other calamity. Since the Ventura Water System is but one operation carried on by the municipality, the water system is not a taxing authority nor has it as

such the authority to borrow funds and thus reach the credit or bonding capacity which might otherwise be provided by outside water customers.

(h) Inside water customers and outside water customers have an entirely different relationship to the Ventura Water System; that difference is clearly demonstrated based upon how the water system was acquired, the burdens incurred by the City and its residents in that regard, and the benefits provided, past, present and future, to the outsiders, by virtue of their previous privately operated systems becoming a City-owned system.

(i) Whether considered in terms of replacement cost or in terms of the simple growth in value in the water system itself since it was acquired by the City of San Buenaventura in 1923, the Ventura Water System is an extremely

valuable asset belonging to the citizens of the City of San Buenaventura.

(j) The outside water customers have no proprietary interest in the water system.

(k) The City is entitled to consider a fair rate of return upon the value of the system as a proper factor in determining the water rate differential between inside and outside water customers.

(l) The methods used by the City of San Buenaventura to determine the reasonableness of water rates for the Ventura Water System are methods commonly used for regulated utilities and in determining rates for out-of-city customers of municipal systems.

(m) Only the City of San Buenaventura as a municipality may obtain governmental grants, utilize city finances and loan funds to assist

the water system, and may utilize other City revenue sources to supplement the financial strength of the water service system.

(n) Plaintiffs seek to reject all the various factors presented in the record before the court, which the City Council as the water rate-making body could consider as legitimate cost considerations in exercising its discretion in setting rates to be charged to various classes of water users.

(o) As previously noted, with respect to anticipated water needs, the City of San Buenaventura, when it had the opportunity in 1970, committed itself to 10,000 acre feet of water rights from the California State Water Project.

(p) When the City of San Buenaventura acquired such 10,000 acre

feet of entitlement, the City was required to reimburse the Ventura County Flood Control District for all of the ongoing payments which the Flood Control District had paid from the date of the initial contract in 1963 up until 1970 when the obligation to make the payments was passed through the Casitas Municipal Water District and ultimately to the City of San Buenaventura.

(q) Thus, the City of San Buenaventura was required to "buy in" from the outset of the project, whereas the plaintiffs in the case at bench indicate that when the future anticipated and ongoing financially contracted water is in fact delivered to the plaintiffs, only then should they have to pay for this future contracted water.

(r) The City's obligation under

the State water contract is estimated at $58 million and the obligations assumed by the City provide that taxes must be levied if revenue should be insufficient to meet the payments under the contract; thus all of the property within the City of San Buenaventura stands as security for a $58 million obligation. No such obligation affects the property of customers located outside the City.

(s) The City's point of delivery of State water is at Lake Castaic, approximately 45 to 50 miles away.

(t) It is the City's obligation to construct the transmission main to bring the water from the State system; this cost is estimated at being in excess of $50 million.

(u) The Brown & Caldwell analysis of appropriate rates to be charged outside customers did not even take to account charging the plaintiffs with

a proportionate share of the principal payments made by the City with respect to the State Water Project.

(v) There are investor-owned utilities whose rates reflect payments made by them for the State Water Project.

(w) As non-city residents, the plaintiffs are not obligated on this ongoing binding contract made by the City of San Buenaventura which provides for the anticipated future needs of the Ventura Water System.

93. Evidence of other unquantified benefits received by plaintiffs from being served by the Ventura Water System included the following: reduced fire hazard to plaintiffs' property due to the City hydrants and back-up system; increased fire flow and better insurance ratings; improved sources of water supply; better

quality water; availability and use of internal financing and an immediate line of credit from City general funds; the availability of contributions to the City from residents of acreage and connection fees for its water system to aid in offsetting rates; the City's action in securing and utilizing grant funds for the benefit of the whole water system when such efforts could have been utilized for purely in-city benefit; no risk or responsibility for running the water system; power tax revenues from City residents only; the efficiency of a large integrated system; the City investment in the State Water Project; City facilities provided for the use of the water system, and other personnel providing services to and for the water system; City facilities purchased, maintained and operated with City general fund monies, not from water

fund monies; and the tax exempt status of facilities within the City which serve the outside users.

94. Revenues from water service charges alone are not sufficient to support the water system since general fund monies and governmental grants, contributions, loans, power tax revenues and acreage and connection fees, not paid by out-of-city users, have been and are necessarily utilized to support the water system, all of which has kept plaintiffs' rates lower than what they otherwise might have been.

95. Plaintiffs are partially subsidized by the free use of City facilities, not a part of the water system, that is being provided by the City for housing water system employees and equipment, and by the City's provision of facilities for numerous other City employees who devote an

enormous amount of time to the water system although their salaries are not paid from the water fund.

96. Plaintiffs benefit from the reliability of the Ventura Water System and availability of different sources of supply; these sources of supply would be available solely to City residents if they were not being utilized for those outside the city limits.

97. New applicants for water service within the City are charged acreage or connection fees to provide front end contributions of equity, the purpose being to provide sources of supply and backup facility for the general benefit of the whole system and to provide for expansion.

98. Plaintiffs benefit from power tax revenues which are revenues derived from insiders and not outsiders, administrative services performed by the

general City government, grants and contributions, the backup capabilities of the water system which are available for fire protection, the low valuation of water rights that the City has placed on its water rights in connection with its review of the rates, internal financing and many other factors.

99. If the City were not serving outside customers, there would be more water and more of the water system resources available for the inside City residents.

F.

UTILITY BASIS ACCOUNTING METHOD

100. A study of the City's outside treated rates made by the Railroad Commission in the early 1940's was also presented to the court.

101. The Railroad Commission sustained the reasonableness of the outside domestic rates then in effect,

which were at that time 48 percent higher than those within the city limits.

102. The Commission, at the request of the City, also reviewed the untreated irrigation rates then in effect.

103. The Railroad Commission did not use its standard practice or method of reviewing investor-owned utility rates but rather utilized the "utility" method of reviewing the treated rates, as did Brown & Caldwell in their study of the 1975- 76 rates and their study of the 1972-73 rates.

104. The utility method is well recognized as an accepted rate-setting method by the American Waterworks Association.

105. The utility method does not take into account certain unquantified benefits which outside water customers receive. All of these benefits,

however, have corresponding costs to inside residents and customers or at the very least diminish the capacity of facilities for use by inside residents; the utility method allows for the inclusion of a rate of return as a cost in setting rates to be charged outside water customers.

106. Such benefits are a cost to the City residents even though they cannot be quantified in terms of an exact dollar amount.

107. The utility method is used in many jurisdictions for outside City service, as well as being applicable to regulated utilities. This accounting method, as well as others, supports the disputed City rates.

108. The rate of return utilized by Brown & Caldwell in their studies was much lower than that granted a number of companies regulated by the

California P.U.C.

109. The Brown & Caldwell review of the effects of the increased rates for plaintiffs for Fiscal Year 1972-73, the first year that a seventy (70%) percent differential went into effect, shows that the result of the City Council action in 1972 was reasonable.

110. The total annual revenue derived from the nonresident potable water users for 1972-73 was $80,241.15 less than the total annual revenue requirements for this class. Based on this, a 98.5% differential in rates was justified without even taking into account the many unquantified benefits and intangible factors which the plaintiffs receive without corresponding burdens.

111. Brown & Caldwell made a cost-of-service analysis, based upon the theory that each customer should pay a

proportionate share of the actual use of the water system.

112. This study determined the appropriate classes of customers as being (1) untreated water users, (2) potable water users within the City, and (3) potable water users outside the City.

113. This study of the rates for Fiscal Year 1975-76 shows that the rates were reasonable.

114. In the Brown & Caldwell Study for Fiscal Year 1975-76, a three (3%) percent rate of return was charged to inside residents, whereas an 8.67% rate of return was allocated to the outside customers.

115. Rate of return is a true economic cost; it is a payment for the use of the property of another.

116. Fair rate of return is the essence of the "utility" method of

setting rates.

117. The City is entitled to a fair rate of return on the value of its water system property and even the plaintiffs' expert, Mr. Knaggs, agreed that the City was entitled to earn a return from its outside water customers.

118. The court agrees with Mr. Knaggs' conclusion that the criteria for the rates should be the benefits to the outsiders.

119. There is a cost difference between serving in-city and out-of-city customers of the Ventura Water System.

120. The court rejects the testimony concerning the opinion that there is "no cost difference" between serving in-city customers and out-of-city customers.

121. The City Council and the Court need not commit itself to any particular method of computing the cost to the City for the water service it provides.

122. The court finds speculative and entitled to no weight the testimony concerning the opinion as to plaintiffs' concept of "cost."

123. Mr. Ferry, in his studies, took the City water rights into account by including them in rate base, but he valued them merely at book value based upon a 1940 appraisal of $1.2 million.

124. Mr. Ferry used this lower figure in reviewing the rates charged to plaintiffs rather than true value.

125. If Mr. Ferry had actually used a current value for the City's water rights, the justifiable surcharge for outside users would have increased to eighty-three (83%) percent in fiscal year 1975-76.

126. While not always used, the Public Utilities Commission of California recognizes the use of current value of water rights in its

proceedings.

127. The City's water rights had no separate original cost; they had been developed largely by use under the law and by careful negotiations. Their current value was conservatively set at $5,000,000.

128. The rates charged out-of-city water consumers were based upon a proper application of utility method rate factors and other cost considerations and methods which the City Council as the rate-making body could properly consider.

129. No evidence was submitted that the rates nor the return being charged the plaintiffs was excessive.

130. Plaintiffs introduced no evidence of unreasonableness of the rate of return or of the rates; conversely, while the need to do so might be in question, the City introduced extensive

and substantial evidence to show beyond a reasonable doubt that the return and the rates are not only reasonable but in fact lower than was justified.

G.

PLAINTIFFS' EXPERT

131. The court finds unconvincing and gives no weight to the testimony of plaintiffs' expert that the rates in question were unreasonable for the following reasons, among others:

(a) Mr. Knaggs did not make a study to identify the cost associated with different classes of customers in Ventura;

(b) Mr. Knaggs was not familiar with the sources of supply for the Ventura Water System;

(c) Mr. Knaggs did not know the cost of any of the sources of supply of the Ventura Water System;

(d) He admitted that the City can

set rates which allow for a rate of return on outside users;

(e) There was no evidence the rate of return on outside users was unreasonable;

(f) His conclusion that plaintiffs' charges included improper expense factors was not supported by evidence;

(g) He improperly concluded that net operating income was the same as net profit.

(h) He agreed that capital expenditures would have to come from what he termed "net profit";

(i) He admitted that it is good prudent practice to set aside reserves for replacements and improvements;

(j) He admitted that providing for depreciation reserve is a good business practice;

(k) The plaintiffs stipulated that

all expenditures from the water system were prudent;

(l) Plaintiffs agreed that all expenditures from the water system were necessary;

(m) Mr. Knaggs agreed that Mr. Heidrick had an outstanding reputation in rate matters;

(n) Mr. Knaggs admitted that rate designs have tremendous variances;

(o) Mr. Knaggs agreed that he would only use revenues and expenses of each class in setting the rates for each such class, which was the same methodology used by City experts;

(p) He admitted that he himself has sometimes recommended to the California Public Utilities Commission that inside-outside differentials remain in effect.

H.

OIL COMPANIES

132. The City Council of the City of San Buenaventura had the right to consider, and in the exercise of its discretion in fact did separately consider, the large volume of water utilized by non-potable industrial water users (oil companies) outside the city limits, and lawfully created a separate classification for such users different from that for outside water customers who required potable water in normal residential or commercial volume.

133. Oil companies were a separate class of customers receiving untreated water, in large quantities; they used virtually none of the City's facilities, and did not engender the same expenses, such as customer service requirements, as the plaintiffs; thus they were and are properly treated as a separate class of customers.

134. The oil company customers

should not subsidize potable water customers.

135. It would be entirely improper to include oil and agricultural revenues and expenses in a consideration of the reasonableness of the rates charged to plaintiffs.

136. Mr. Knaggs agreed that it is reasonable to have different classes of customers, such as treated and untreated customers.

137. Mr. Knaggs had no objections to setting different or lower rates for industrial users.

138. The customer classifications of the City were proper and based upon differences in the classes since one must look at the revenues and expenses of each class of customers to arrive at reasonable rates for each such class; the rates plaintiffs are charged are designed to reflect some of these

differences.

139. Mr. Knaggs' conclusion that one should not exclude any class of income at the outset of a study was the same conclusion reached by the City's experts, who did not exclude any class of income at the outset of any of the studies in evidence.

140. The court finds speculative and entitled to no weight Mr. Knaggs' (plaintiffs' expert) conclusion that improper techniques were used by the City in excluding income and expense of industrial and agricultural customers, as this was contrary to his own opinion that he would first look to the total revenues and expenses, and then separate the revenues and expenses attributable to each class of customers, the same method utilized by the City's experts.

141. The data supplied by the City to Wilsey & Ham in 1970 did not separate

treated revenue and expenses from untreated revenue and expenses and only identified oil companies as large customers.

142. Thereafter, Wilsey & Ham were informed that the City intended to consider separately the operating expenses and revenues which were obtained from oil company sources, particularly Shell Oil Company and Getty Oil Company, who were receiving untreated water and did not necessitate the same expenses as treated water customers.

143. Mr. Heidrick reviewed the Wilsey & Ham Report with this new information and concluded that a surcharge of at least seventy (70%) percent on outside potable water customers would be justified, based upon a very conservative rate of return.

144. Upon completion of this study

the rates were studied by City staff and the Water Problems Committee, and updated figures were obtained and recommendations made to the City Council; sixteen (16) months after the completion of the Wilsey & Ham study another ten (10%) percent overall rate increase was adopted and the outside rates were adjusted to reflect their challenged form.

145. Mr. Heidrick testified that certain factors contained in his recommendation would not now be taken into consideration by him but that other rational factors not included therein should be taken into consideration.

I.

ENTERPRISE FUND

146. The fact that the Ventura Water System is regarded as a separate revenue producing enterprise division within the City is of no significance, other than

to establish a fair financial accounting basis for determining reasonable water rate charges to inside and outside users based upon legitimate customer classifications.

147. None of the water system revenues are used to defray the general expense of the City government.

148. Plaintiffs stipulated that all expenditures by the water system were prudent and that the City did not have to show that the use made of net operating income was necessary.

149. The City of San Buenaventura is not a profit-making enterprise business, but is instead, as a chartered city under the law, charged with the obligation of providing its City residents with numerous municipal services through its duly elected City Council at the lowest dollar cost, consistent with prudent municipal

administration.

150. To seek to impose some claim or privilege in favor of the plaintiffs because the revenue and expenses of the water system are accounted for in a separate internal City operation which over the years has generally proven to be self-sustaining, completely begs the issue.

151. Because of City ownership of the water system and because this activity has been partially supported by user charges and partially by general tax revenues, grants, acreage fees, the City's bonding ability and other sources, the so-called "enterprise fund" may more appropriately be named a special revenue fund. Because of the revenue pattern, it was unclear which term to use and since a substantial amount of the revenues used to finance the activity is derived from user

charges, it could properly be called an enterprise fund with the recognition that it is not self-supporting.

152. The fact that the Ventura Water System is substantially self-supporting in the sense that it is able to operate generally within the framework of the revenue produced by the water system, simply demonstrates that the Ventura Water System is in fact being operated in an efficient manner, and is producing and providing quality water service to all customers within the water service area at a reasonable water rate charge.

J.

MISCELLANEOUS

153. To the extent these findings of fact constitute conclusions of law, they are so intended to be.

CONCLUSIONS OF LAW

1. A water rate differential for outsiders does not render the rates per

se unreasonable and discriminatory.

2. A municipally owned water system may differentiate, in respect to rates, between consumers within and those outside of the municipality when the differentiation has a rational basis.

3. Lack of uniformity in the rate charged is not necessarily unlawful discrimination, and is not prima facie unreasonable.

4. The City may classify its customers upon any reasonable basis.

5. The City's rate structure properly distinguishes between classes of customers and attempts to apportion cost.

6. Differing circumstances justify different rates.

7. A class uncommitted to the growth and development of facilities may logically be classified differently as in this case and may be charged higher

rates than a class which is committed to aid in such growth and development.

8. The court has examined the genesis and antecedents of each class to determine the rational basis of the classification.

9. No rate differential would be the equivalent of a differential in favor of those who live outside the City.

10. In many ways, City government has provided support and stability for the water system.

11. The City boundary line, at the very least, divides the inhabitants of the City for whose primary benefit the system was developed from those who have no such claim.

12. The City boundary line also serves to divide those customers who have made a capital contribution to the system, who have assumed responsibility for its operation, and who have, through

general municipal functioning, contributed to its support and development, from those who have not.

13. Many costs are intangible such as the risk of loss from fire or other unforeseen calamity, b#t some allowance must be made for such costs.

14. A city could properly determine that no part of the burden of furnishing water to consumers outside the City should be placed on the citizens and consumers within the city limits.

15. Two different classes of consumers may properly be charged on a different basis without working any unlawful preference or discrimination.

16. Outside water customers of a municipally owned system do not have an absolute right to be treated on the same basis as City residents.

17. The ordinance in question does not violate the equal protection or due

process clauses since the distinction between classes of customers clearly rests upon a rational basis.

18. The evidence in this case is replete with valid court tested reasons supporting the distinction that has been made between resident potable water users and nonresident potable water users.

19. These non-resident plaintiffs can constitutionally be treated differently.

20. The plaintiffs are not in the same position as City residents, and they do not have to be treated equally since there is a rational basis for the differing classifications.

21. Improper discrimination has not been shown.

22. The difference in rates is based upon a reasonable and fair difference in conditions which equitably and logically

justifies a different rate.

23. Outside users do not have the same burdens, risks or responsibilities as those within the City.

24. All property within the City stands as security for a $58 million obligation under the State water contract.

25. The City made a prudent decision in contracting for a long-range supply of water from the State Water Project; that decision is not without risk, and the risk falls upon City residents only.

26. The seventy (70%) percent user charge differential imposed on outside customers does not represent the effective differential with respect to the City user who has paid the acreage or connection fee.

27. The court must look to the revenues and expenses of each class to arrive at reasonable rates for each such

class.

28. The Ventura Water System continually calls upon sources other than rates to meet its current and long-term expenses; these sources include the credit of the City, grants, acreage fees, connection fees, loans from the general fund, and employee services and facilities paid for by general fund monies, including taxes.

29. The classification of customers by the City is based upon differences in the classes and the rates being charged the outside potable water customers are reasonably designed so as to reflect some of the differences.

30. Guarantees of equal protection are not violated by the fact alone that the ordinance treats one class differently from another.

31.Where, as here, no suspect classification is involved and purely

economic interests are at stake, the City may draw any distinction between classes which bears some rational relationship to a conceivably legitimate state purpose.

32. Wide discretion is vested in the City Council in making the classification and every presumption is in favor of the validity of the ordinance.

33. The decision of the City Council as to what is a sufficient distinction to warrant the classification should not be overturned by the court unless it is palpably arbitrary.

34. A distinction in legislation is not arbitrary if any reasonably conceivable set of facts will sustain it.

35. The wells of both the Mound and Saticoy companies failed to meet Health

Department standards, and it was proper for the City to shut them down when the City took over their respective systems.

36. Neither company owned nor provided the City with water rights or a usable water supply which could be used to continue to supply the former Mound and Saticoy customers.

37. The City's own water rights (Foster Park diversions and wells) were insufficient to supply its existing customers, and the City was already required to purchase water from Casitas Municipal Water District and Alta Mutual.

38. Because the Mound and Saticoy customers in effect brought no water supply with them, the City was required to purchase additional amounts of water in order to serve them.

39. If the physical facilities had

been in existence to connect the Mound and Saticoy systems to better quality water, those companies would have been required to improve their water supplies at substantial increases in cost.

40. The Stetson analysis essentially concludes that plaintiffs should properly pay for the water just described.

41. The plaintiffs' position is that they are entitled, as a matter of law, to share in the City-owned water supplies (Ventura River rights and wells) even though those supplies were fully committed, and even though plaintiffs are not part of the City.

42. To accept plaintiffs' position would mean that providing service to the outside customers would increase the cost to every user in the City because every in-city user would have to help buy the more expensive water that has to

be purchased to accommodate the outside users.

43. If no surcharge were permitted, the situation would constitute the equivalent of a differential in favor of the outside customers.

44. In assigning the outside users the cost of sufficient Casitas water to supply them, Mr. Stetson has done nothing more than the Health Department would have required had the outside users remained on their own and had Casitas water been physically available to the Mound and Saticoy companies.

45. In his analysis, Mr. Stetson did what the Health Department requires and the City is entitled to apportion those costs to those who benefit.

46. The Stetson analysis deals only with operational costs; it does not take into account capital costs or depreciation.

47. The evidence demonstrates that actual additional costs are involved in serving the outside users.

48. If those costs are not reflected in higher outside rates, then the costs of City users will be correspondingly increased.

49. The court is not required to determine all of these costs nor balance them with precision against rates.

50. The court is only required to decide whether a rational basis exists for charging different rates and whether the rates are reasonable; clearly both are so.

51. Because of the City ownership of the water system and because this activity is partially supported by general tax revenues, grants, acreage fees, the City's bonding ability and other sources, and not only by user charges, the enterprise fund may more

appropriately be called or labeled a special revenue fund.

52. Plaintiffs do not have a right to receive water service at the same charge as that made to residents within the City.

53. This court does not have jurisdiction to set rates but merely to determine whether the rates fixed were reasonable and fair.

54. If a difference in rates is based upon a reasonable and fair difference in conditions which equitably and logically justifies a different rate as in the instant case, there is no unjust discrimination.

55. Since there is a valid distinction in customer classes, there is no cause of action for discrimination in the absence of allegation and proof that the charges paid by plaintiffs were unreasonable and excessive.

56. Inequality of charges standing alone is not per se actionable.

57. Charges to these plaintiffs cannot be deemed unduly discriminatory unless they are also unreasonable, in the sense of being excessive.

58. The water rates charged to plaintiffs generate approximately enough revenue to equal the "revenue requirements" for plaintiffs as calculated using the utility method.

59. The reasonableness of rates depends on whether the amount of charges for each class, taken separately, are supportable.

60. In determining whether a rational basis exists for the water rates, the court is to look at the result and is not confined to matters which may have been before the City Council, the rate-setting body.

61. Whether the rates are just and

reasonable, or unjust and unreasonable, must be ascertained by the court from its own investigation.

62. If any state of facts can reasonably be conceived that would sustain the rates, they should be upheld.

63. Reasonableness of the rates being charged these plaintiffs was an object of this court's inquiry.

64. The rates charged to plaintiffs are not excessive or unreasonable.

65. Higher charges by municipalities for non-resident water users are not an unusual method of pricing.

66. The courts have found varying reasons to support differentials, only one or two of which may be cited in each instance. Some of the reasons are:

(a) A municipality is entitled to earn a return on its plant and facilities serving the outsiders.

(b) A municipal government can tax its own residents, but not the non-resident water users.

(c) The City has lent its credit to the utility, thus enabling the financing of water projects upon more favorable terms.

(d) The outsiders, having foregone nothing and shared in no risk in building up the plant, cannot expect to share in the benefits accruing from City ownership.

(e) A municipality is entitled to recover the cost of fire protection from outsiders, standby water demand being greater by the addition of outside areas.

(f) The payment of water system expenses out of a City's general fund.

(g) The necessity to fix a differential which shall equalize the disparity between rates and taxes or general fund

monies.

67. A higher rate for outside users does not, in itself, render the rate charged outside users objectionable as offending the due process or equal protection clauses of the Federal or State constitutions.

68. Plaintiffs presented no credible evidence that the rates in question were unreasonable.

69. It has been shown that the rates are not only reasonable but were in fact conservative.

70. The results following the increase in rates adopted by the City Council in 1972 demonstrated that a non-resident rate differential of 98.5% would have been justified as shown by the uncontradicted evidence that the revenue requirements of non-resident potable water users were $80,241.15 more than actually charged in the applicable

fiscal year.

71. A difference in the rate of return is not unlawful when there is a valid difference in customer classifications and when the rate standing by itself is not unreasonable.

72. It is not feasible to quantify all of the benefits received by the Mound and Saticoy customers when they were connected to the Ventura Water System; these benefits were and are nonetheless real and of substantial value.

73. The outside rates were fair and reasonable, whether considered alone or in terms of the differential, and were justified on the basis of any of the separate approaches to rate-making included herein.

74. If the City had been required to construct additional storage tanks, or large transmission mains, or added treatment facilities in order to supply

the outside customers, such costs would be taken into account in setting outside rates.

75. Such facilities were in fact needed and were in fact used to supply the outside customers.

76. The fact that some of such facilities had already been constructed by the City, for the benefit of their own future growth, does not make them of less value to the outside customers, or of less cost to the City users.

77. Because of the revenue pattern for the City water system, it was unclear which term to use to describe the water fund; since a substantial amount of the revenues used to finance the water system is derived from user charges, the fund could properly be treated as an enterprise fund with the recognition that it is not

self-supporting.

78. In this proceeding the role of the court is not to substitute its judgment for the judgment of the City Council or to fix the rate, but to determine whether the rate already established is discriminatory or unreasonable.

79. Each case must depend very largely upon its own special facts and every element and every circumstance which increases or depreciates the value of the property involved or of the services rendered should be given due consideration and allowed that weight to which it is entitled; appropriate setting of rates is, after all, very much a question of sound and well instructed judgment.

80. There is no rule of law which prevents the City's charges from being above or below a particular sum, or

requires that the service shall be exactly along the same lines.

81. The charges in question have a reasonable relation to the difference in customer classes and do not produce unjust discrimination.

82. This court does not sit to determine whether the governmental entity has chosen the soundest or most practical method of reaching its objective, since authority to make those judgments rests solely with that entity.

83. The water rates in question were fixed by a lawful rate-fixing body, i.e. the City Council of the City of San Buenaventura.

84. The utility basis accounting method substantiates the City rates; this method requires a determination of the rate base, which is the value of the property on which the utility is entitled to earn a return; after the

rate base is established, it is necessary to fix a fair rate of return on the rate base.

85. One of the elements in establishing the rate base is the cost of capital, which includes interest payments on debt and equity capital.

86. Two methods are commonly used for the determination of rates; the cost and the utility methods.

87. These methods differ only in that the latter allows for a fair rate of return.

88. The utility method is normally used by regulated investor owned utilities and by regulated municipal utilities.

89. The utility method has also been extensively used and appears to be one of the most appropriate methods for municipal utilities to use in establishing rates for nonresident

users.

90. The utility method is recommend#d for use by the American Waterworks Association.

91. The utility method was accepted by the Railroad Commission in the 1940s as an acceptable and appropriate method to review the outside potable rates being charged by the Ventura Water System.

92. The report of the Railroad Commission and other authorities support including contributed plant in the rate base upon which a return is allowed.

93. The report of the Railroad Commission and other authorities support including grants in the rate base upon which a return is allowed.

94. The return on rate base is needed to provide for capital-related costs of system development, replacement and expansion.

95. The rate of return utilized by Brown & Caldwell was reasonable and no evidence was submitted to demonstrate that it was excessive.

96. The plaintiffs have brought forth no evidence to support a finding that the rate of return charged by the City is unreasonable.

97. Conversely, the City has submitted to this court a number of studies which indicate the reasonableness of the rate of return utilized in the studies.

98. The court concludes the rate of return is not unreasonable.

99. If the City chooses to supply water to its citizens without including a rate of return in its charges, it is under no obligation to serve outside the City on the same basis.

100. Return on rate base may be waived entirely or in part for resident

users.

101. Privately owned and municipally owned utilities should not be treated so as to allow the former a return and the latter no return.

102. The City is entitled to earn a return on the rate base from the outside treated water customers.

103. The function of the "return on rate basis" is considered in rate-making as a "cost."

104. The non-resident rates have raised only approximately enough revenue to meet the "revenue requirements" of serving the outside users.

105. The revenue requirements attributable to outside users are a composite of the operating and maintenance expenses attributable to outside users, the property taxes and accrued depreciation attributable to outside users, and a reasonable "return"

on the portion of the plant serving outside users.

106. The City employed independent consulting firms to undertake comprehensive cost of service studies for the entire system so as to allocate respective expenses attributable to each class of customer.

107. There is a zone for reasonableness within which rates can be set.

108. Whether one values the Ventura Water System at original cost or current cost makes no difference since the rate of return would be adjusted depending upon which method was used.

109. Rate designs have tremendous variance.

110. The studies conducted by the City did exactly what Mr. Knaggs advocated: to get an overall picture of the whole system, the City's consultants

looked at total revenues and expenses; then to arrive at rates for different classes of customers, they looked at revenues and expenses attributable to that class so that one class, i.e., untreated customers, would not be subsidizing another class, i.e., treated customers.

111. The City developed a pricing policy which recovered the revenue requirements of the raw water customers by incremental costing, which was a proper way to determine the revenue requirements for the raw water customers.

112. These revenues were then subtracted from total revenue requirements to develop revenue requirements for potable water customers.

113. The City's costs of the purchased water for such industrial

customers were then excluded from the studies on treated water rates conducted for the City; any other costs not included were de minimus.

114. The plaintiffs are not bearing more than their just and reasonable share of the burden of maintaining, operating, and continuing the City's treated water system.

115. The untreated water rates as a whole are sufficient to raise enough revenue to adequately continue, maintain, and operate the untreated system.

116. Plaintiffs make the fallacious assumption that they may challenge the reasonableness of the rate by attacking the method by which a rate engineer arrived at his recommendation to the City.

117. The plaintiffs did not show what a reasonable rate should be or that the rate established was not reasonable.

118. Where a utility has a class of limited customers, it is not necessary that it go to the time and expense of a rate investigation for the entire system before adjusting the rate for the class, if there is an otherwise reasonable basis for arriving at the rate.

119. The overall look at the rates charged to plaintiffs, involving many factors, clearly demonstrates that they are reasonable.

120. The outside rates are fair.

121. The courts will not dictate the method to be used in setting rates; it is the result which will be looked at to see if the result is unreasonable.

122. Comparing the City industrial water rates with those for non-resident domestic service is not helpful and is not proper since the services are of an essentially different character.

123. The burden was on the

plaintiffs to establish the non-existence of the presumed fact, i.e., that the rates fixed were unreasonable, unfair or unlawful.

124. Plaintiffs failed to prove by a preponderance of the evidence or by any credible evidence that the water rates in question were unfair, unlawful, unreasonable, discriminatory or violative of equal rights.

125. Although the burden was on the plaintiffs to establish that the rates fixed were unreasonable, unfair or unlawful, the defendant proceeded to introduce credible and overwhelming evidence that the water rates in question were in fact reasonable, fair and lawful, and the court so concludes.

126. Although this court has viewed the rates in question based upon the premise that they are presumed reasonable and the burden is upon those

attacking the rates to show that they are unreasonable or discriminatory, the court has also looked at the rates in question without this presumption, and has concluded that the defendant has amply demonstrated by the preponderance of the evidence that the rates are reasonable and are in fact lower than what they could have been.

127. Presuming that the burden of producing evidence to justify the difference in rates shifted to the City, the City has amply demonstrated beyond a reasonable doubt that the rates being charged the plaintiffs are in fact reasonable and that the City has shouldered many hidden overhead expenses attributable to the operation of the water system out of its general fund and has subsidized the plaintiffs to a great extent.

128. When a rate-setting body sets

charges to be made for services, it is presumed that the rate-setting body has acted reasonably.

129. The inside treated water rates are reasonable and the outside treated water rates are reasonable; both rates met the requirements of the Revenue Bond Act.

130. The Revenue Bond Act does not preclude charging a rate of return.

131. There is no "profit" being generated from the non-resident rates in the sense of extra money being available to pay dividends to shareholders, or to make transfers from the Ventura Water System to the general fund of the City.

132. No water revenues have been transferred to the City's general fund.

133. Equality of treatment does not mean identity of treatment.

134. It is only arbitrary discriminations that are unjust or

unconstitutional.

135. The question of discrimination narrows itself to a determination of whether discrimination, conceding it to exist, is just, i.e., based on reasonable grounds, or is unjust, i.e., merely arbitrary.

136. In the area of economic regulation, including rate classifications, the standard of review is the rational basis test.

137. No matter what standard of review is used, it has
been fully demonstrated that the customer classes and rates in question are reasonable.

138. The cases which the plaintiffs have cited, where the court found a compelling state interest test to be applicable, all involved discrimination within a class of otherwise "qualified electors" possessing the right to vote.

139. It is only when the disenfranchised can demonstrate that they are among a class of qualified electors that the compelling state interest test comes into play.

140. The plaintiffs have not been deprived of a fundamental right.

141. The ordinance in question does not violate the Equal Protection Clause of the 14th Amendment.

142. The plaintiffs have not been deprived of their fundamental right to vote.

143. The court concludes that plaintiffs' argument that dividing water users into those living inside the city limits and those living outside the city limits places those living outside in a suspect classification is unsound.

144. The courts are extremely hesitant to extend the suspect classification status and the compelling state interest

test into other areas.

145. It is possibly for this reason that the plaintiffs have most strongly urged this court to find that the outside water users are akin to aliens, and as aliens any classification must be founded upon a compelling state interest.

146. The obvious distinction between persons living outside the city limits and persons who are aliens is that aliens have no right to vote in any election, be it city, county, state or national; whereas persons residing outside the city limits merely cannot vote in city elections.

147. This court further disagrees with the "alien" analogy as the outside users are not a discrete and insular minority requiring strict judicial scrutiny. Nor are they saddled with such disabilities or subjected to such a history of

purposeful unequal treatment, or relegated to such a position of political powerlessness as to command extraordinary protection from the political process.

148. The plaintiffs do not possess the attributes which would require them to be looked upon as a suspect classification and, therefore, entitled to the extraordinary protection of invoking the "compelling state interest" standard.

149. Neither a fundamental right nor a suspect classification being involved, the inquiry becomes whether the ordinance bears some rational relationship to a legitimate purpose; this, in turn, is decided by whether there is any conceivable state of facts to justify the ordinance.

150. Since the law allows the City to extend its services outside the city limits, a legitimate state interest

exists in providing for the general welfare of the people through promotion and development of the outlying areas.

151. This court agrees with the U. S. Supreme Court in its ruling in Holt Civic Club v. City of Tuscaloosa, which held that an ordinance much like that here in Ventura is not unconstitutional even though the outside residents have no right to vote in City elections as they are not qualified voters in those elections.

152. The court takes judicial notice of California Railroad Commission Decision No. 9958, dated December 31, 1921.

153. Plaintiffs have not presented sufficient evidence to conclude that the City has acted in excess of its jurisdiction.

154. The City possesses the authority to extend its water service outside the

City subject to the requirement that the rates be reasonable.

155. Contrary to the contention of the plaintiffs, the outside users are not without recourse and are not at the mercy of the City since they have recourse to the court system to scrutinize the reasonableness of the rates set by the City Council.

156. The rates in question can only be contested if they discriminate so as to make some pay more than their just and reasonable share of the burden of maintaining, operating and continuing the City's water facilities.

157. To the extent these Conclusions of Law constitute findings of fact, they are so intended and may be so deemed.

DATED: Aug. 8, 1981

Robert D. Carter
Judge of the Superior Court, Assigned

SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE COUNTY OF VENTURA

FILED
AUG 17, 1981
ROBERT L. HAMM, County Clerk

JUDGMENT

NO. 55769

MAGDALINE M. HANSEN, individually and on behalf of all those similarly situated,

Plaintiffs,

v.

THE CITY OF SAN BUENAVENTURA,

Defendant.

This cause came on regularly for trial in May, 1978, before the Honorable Robert Carter, Judge Assigned, presiding, sitting without a jury, a jury having been duly waived.

Plaintiffs appeared by their attorney Robert S. Stone. Defendant City of San Buenaventura appeared by its

attorneys Michael R. Dougherty, Assistant City Attorney, and Arthur L. Littleworth, as special counsel.

Evidence, both oral and documentary, having been presented by both parties, the cause having been duly argued and submitted for decision, and the Court being fully apprised in the premises, and the Court having caused to be made and filed herein its written Findings of Fact and Conclusions of Law which are incorporated herein by reference,

IT IS ORDERED, ADJUDGED AND DECREED that the defendant have judgment against the plaintiffs as follows:

1. The request for declaratory relief is denied.

2. Ordinance No. 1727 originally enacted by defendant on May 15, 1972 is valid and the rates charged thereunder to plaintiffs did not improperly

discriminate against plaintiffs.

3. Plaintiffs shall take and recover nothing by virtue of the complaint herein.

4. Judgment is to be entered in favor of defendant.

5. Defendant shall recover costs from plaintiffs in the sum of $1,727.83.

DATED: Aug. 8, 1981

ROBERT W. CARTER
Judge of the Superior Court, Assigned

Supreme Court
FILED
MAR 23 1987
Laurence P. Gill, Clerk

Deputy

In the Supreme Court of the
State of California

Supreme Court No. L.A.32091
Ct. of Appeal No. 67886
Super. Ct. No. 55769

MAGDALINE M. HANSEN, individually and on behalf of all those similarly situated,

Appellants

v.

CITY OF SAN BUENAVENTURA,

Appellee.

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

Notice is hereby given that MAGDALINE M. HANSEN, individually and on behalf of all those similarly situated, the appellants above-named, hereby appeal to

the Supreme Court of the United States from the final judgment of the Supreme Court of the State of California, entered in this action on December 31, 1986. Appellants' timely petition for rehearing was denied on February 5, 1987.

This appeal is taken pursuant to 28 U.S.C. section 1257(2).

HELENE STONE
Counsel for Appellants

STONE AND STONE
A Professional Law Corporation
Suite 208 D
674 County Square Drive
Ventura, California 93003
(805) 654-1144

MUNICIPAL ORDINANCES INVOLVED

Ordinance No. 1727 of the City Council of the City of San Buenaventura provides, in pertinent part, as follows:

"Sec. 4521.1--INSIDE CITY LIMITS. The meter rate for water sold, supplied, distributed, or transported to consumers within the City, unless otherwise herein specified, shall be determined as follows on a monthly basis:

Cubic Feet	Per 100 Cu. Ft.
000 to 1,000 inclusive	$ .4730
1,001 to 10,000	.3960
10,001 to 100,000	.3080
100,001 to 500,000	.2200
500,000 to 1,500,000	.1320
In excess of 1,500,000	.1265

Provided that the minimum monthly rates for water service shall be as follows:

Meter Size	Monthly Minimum	Bi-monthly Minimum
5/8" x 3/4"	$ 4.26	$ 8.51
3/4" x 3/4"	4.73	9.46
3/4" x 1"	6.51	13.02
1"	8.30	16.59
1-1/2"	12.06	24.11
2"	15.82	31.64
3"	23.34	46.68
4"	30.87	61.73
6"	40.37	80.74
8"	55.77	111.54
10"	71.17	142.34

. . .

"Sec. 4521.2--OUTSIDE CITY LIMITS. The meter rate for water sold, supplied, distributed or transported to consumers outside the City, unless otherwise specified, shall be as follows:

Cubic Feet	Per 100 Cu. Ft.
000 to 1,000 inclusive	$ .8041
1,001 to 10,000	.6732
10,001 to 100,000	.5236
100,001 to 500,000	.2200
500,000 to 1,500,000	.1320
In excess of 1,500,000	.1265

Provided that the minimum monthly rates for water service shall be as follows:

Meter Size	Monthly Minimum	Bi-monthly Minimum
5/8" x 3/4"	$ 7.24	$ 14.47
3/4" x 3/4"	8.04	16.08
3/4" x 1"	11.07	22.14
1"	14.10	28.20
1-1/2"	20.50	40.99
2"	26.89	53.78
3"	39.68	79.36
4"	52.47	104.94
6"	68.63	137.26
8"	94.81	189.61
10"	120.99	241.97

. . .

"...The rates established by this Ordinance shall apply to all water sold, supplied, distributed or transported to consumers on and after July 1, 1972."

Ordinance No. 75-29 of the City Council of the City of San Buenaventura provides, in pertinent part, as follows:

"Sec. 4521--Rates. The rates set out in this article shall be charged for all water sold, supplied, distributed or transported by the City, except as may be established by contract or elsewhere provided in this code.

. . .

"4521.1--Inside City Limits. The meter rate for water sold, supplied, distributed, or transported to consumers within the City, unless otherwise herein specified, shall be determined as follows on a monthly basis:

Quantity in Cubic Feet	Rate per 100 Cubic Feet
0 - 600	$4.50 minimum
601 - 10,000	0.47
10,001 -100,000	.38
Over 100,000	0.28

Provided that the minimum monthly rates for water service shall be as follows:

Meter Size	Monthly Minimum	Bi-monthly Minimum
5/8" x 3/4"	$ 4.50	$ 9.00
3/4" x 3/4"	6.00	12.00
3/4" x 1"	7.50	15.00
1"	9.00	18.00
1-1/2"	16.00	32.00
2"	24.00	48.00
3"	44.00	88.00
4"	67.00	134.00
6"	122.00	244.00

8"	189.00	378.00
10"	267.00	534.00

. . .

"Sec. 4521.2--Outside City Limits. The meter rate for water sold, supplied, distributed, or transported to consumers outside the City, unless otherwise specified, shall be determined as follows per meter on a monthly basis:

Quantity in Cubic Feet	Rate per 100 Cubic Feet
0 - 600	$7.65 minimum
601 - 10,000	0.80
10,001 -100,000	.65
Over 100,000	0.28

Provided that the minimum monthly rates for water service shall be as follows:

Meter Size	Monthly Minimum	Bi-monthly Minimum
5/8" x 3/4"	$ 7.65	$ 15.30
3/4" x 3/4"	10.20	20.40
3/4" x 1"	12.75	25.50
1"	15.30	30.60
1-1/2"	27.20	54.40
2"	40.80	81.60
3"	74.80	149.60
4"	113.90	227.80
6"	207.40	414.80
8"	321.30	642.60
10"	453.90	907.80

. . .

"Sec.4521.3--Raw Water Rates. Irrigation rates for raw water. For each 100 cu. ft. or fraction thereof $0.14 per 100 cu. ft.
....

"Sec. 4521.4--Treated Water for Irrigation. Treated water for irrigation uses shall be at the rates as outlined in Sections 4521.1 and 4521.2.

. . . .
"This ordinance shall take effect on the 31st day after fial passage and adoption.

"Passed and adopted this 18th day of August, 1975."

Ordinance No. 77-27 of the City Council of the City of San Buenaventura provides, in pertinent part, as follows:

> "Sec. 4521.1--Inside City Limits. The meter rate for water sold, supplied, distributed or transmitted to consumers within the City, unless otherwise herein specified, shall be $0.54 per 100 cubic feet. Billing shall be on a bi-monthly basis ....
>
> The meter rate for water sold, supplied, distributed or transported to commercial or industrial customers in the City within a bi-monthly billing period shall be determined as follows:

Quantity in Cubic Feet	Rate per 100 Cubic Feet
0 -2000	$0.54
Over 2000	$0.30

"Sec. 4521.2--Outside City Limits. The meter rate for water sold, supplied, distributed or transported to consumers outside the City, unless otherwise herein specified, shall be $0.92 per 100 cubic feet. Billing shall be on a bi-monthly basis. ....

The meter rate for water sold, supplied, distributed or transported to commercial or industrial customers outside the City within a billing period shall be determined as follows:

Quantity in Cubic Feet	Rate per 100 Cubic Feet
0 -2000	$0.92
Over 2000	$0.30

. . .

"This Ordinance shall take effect on the 31st day following its final passage and adoption.

Passed and adopted this 20th day of June, 1977."

No. 87-51 (2)

Supreme Court, U.S.
FILED
SEP 2 1987
JOSEPH F. SPANIOL, JR.
CLERK

In The
Supreme Court of the United States
October Term, 1987

MAGDALINE M. HANSEN, individually and on behalf of all those similarly situated,

Appellants,

v.

CITY OF SAN BUENAVENTURA,

Appellee.

ON APPEAL FROM THE SUPREME COURT
OF THE STATE OF CALIFORNIA

MOTION OF APPELLEE CITY OF SAN BUENAVENTURA TO DISMISS OR AFFIRM

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**Counsel of Record*

52 pp

QUESTIONS PRESENTED

1. Was it unconstitutional for the California Supreme Court to uphold separate customer classifications and rates based upon differences in cost of service, contributions and risks, and the need to purchase a replacement water supply for outside-City customers?

2. Was it proper for the California Supreme Court to allow Ventura to recover a return on the investment in City facilities devoted to the use of outside-City customers?

3. Did the California Supreme Court properly determine that Ventura's rate differential was not based solely on the nonresident status of outside-City customers, and that the City had not discriminated against them?

4. Was the Court entitled to consider expert testimony and other evidence to review the reasonableness of the City's rate schedule?

PARTIES TO PROCEEDINGS BELOW

Original parties before the California Supreme Court: (1) Magdaline M. Hansen, individually and on behalf of all those similarly situated, the appellants herein; and (2) the City of San Buenaventura ("Ventura"), the appellee herein.

Amici curiae, before the California Supreme Court, by permission of the Court: the cities of Antioch, Beverly Hills, Camarillo, Chico, Covina, Del Rey Oaks, Huntington Beach, Los Angeles, Marina, Napa, Needles, Palm Springs, Riverside, Roseville, Sacramento, San Francisco, South Lake Tahoe, and Tustin.

TABLE OF CONTENTS

		Page
Questions Presented.....		i
Parties to Proceedings Below.....		iii
Table of Contents.....		iv
Table of Authorities.....		v
Statement of the Case.....		2
I.	THE JUDGMENT RESTS ON AN ADEQUATE NON-FEDERAL BASIS. NO SUBSTANTIAL FEDERAL QUESTION IS PRESENTED.....	9
II.	STANDARD OF REVIEW UNDER THE EQUAL PROTECTION DOCTRINE.....	19
III.	APPELLANTS WERE NOT "SINGLED OUT" FOR UNREASONABLE DISCRIMINATION.....	25
	A. The Validity Of The Ventura Rate Ordinances Are Not To Be Determined On The Basis Of Appellants' Claimed "Actual And Articulated Purposes".....	30
IV.	THE CITY OF VENTURA IS ENTITLED TO A RATE OF RETURN ON THE FACILITIES DEVOTED TO THE USE OF OUTSIDE-CITY CUSTOMERS.....	35
V.	CONCLUSION.....	41

TABLE OF AUTHORITIES

Pages

A. U.S. Supreme Court Decisions

Alabama Pub. Serv. Com. v. Southern R. Co., 341 U.S. 341; 95 L.Ed. 1002 [1951]..... 18

Barringer & Co. v. United States, 319 U.S. 1; 87 L.Ed. 1171 [1943]..... 19

Bi-Metallic Invest. Co. v. State Bd. of Equalization, 239 U.S. 441, 445; 60 L.Ed. 372, 375 [1915]..... 31

Central Hudson Gas v. Public Service Comm'n, 447 U.S. 557, 569; 65 L.Ed.2d 341 [1980]..... 21

Cleburne v. Cleburne Living Center, 473 U.S. 432; 87 L.Ed.2d 313, 320-21 [1985]..... 21

Dandridge v. Williams, 397 U.S. 471, 485; 25 L.Ed.2d 491 [1970]..... 9,22

Federal Power Com. v. Hope Nat. Gas Co., 320 U.S. 591, 602; 88 L.Ed. 333, 345 [1944]..... 10,32

Holt Civic Club v. Tuscaloosa, 439 U.S. 60; 58 L.Ed.2d 292; 99 S.Ct. 383 [1978]..... 23

McDonald v. Bd. of Election Com. of Chicago, 394 U.S. 802; 22 L.Ed.2d 739 [1969].... 10

McGowan v. Maryland, 366 U.S. 420; 6 L.Ed.2d 393 [1961]..... 10

Minnesota v. Clover Leaf Creamery Co., 449 U.S. 456; 66 L.Ed.2d 659 [1981]..... 21

New Orleans v. Dukes, 472 U.S. 297; 49 L.Ed.2d 511 [1976]..... 22,23

San Diego Land & Town Co. v. National City, 174 U.S. 739; 43 L.Ed. 1154 [1899]..... 31

Schad v. Mt. Ephraim, 452 U.S. 61, 68; 68 L.Ed.2d 671 [1981]..... 22

U.S. Railroad Retirement Bd. v. Fritz, 449 U.S. 166, 176; 66 L.Ed.2d 368 [1980].... 22

Wisconsin v. Federal Power Comm., 373 U.S. 294, 309; 10 L.Ed.2d 357, 368 [1963]..... 33

B. Other Federal Decisions

Spring Valley Water Works v. San Francisco, 124 F. 574, 584-85 [C.C.N.D. Cal. 1903]..... 33

C. State Court Decisions

American Microsystems, Inc. v. City of Santa Clara, 137 Cal.App.3d 1037; 187 Cal.Rptr. 550 [1982]..... 31

Bowers v. Bernards, 150 Cal.App.3d 870, 873; 197 Cal.Rptr. 925 [1984]..... 18

City & County of San Francisco v. Western Air Lines, Inc., 204 Cal.App.2d 105, 137; 22 Cal.Rptr. 216 [1962]..... 18

County of Inyo v. Public Utilities Com., 26 Cal.3d 154, 159-60; 161 Cal.Rptr. 172, 604 P.2d 566 [1980]..... 9,33

Curtis v. Board of Supervisors, 7 Cal.3d 942; 104 Cal.Rptr. 297, 501 P.2d 537 [1972]..... 23

D'Amico v. Board of Medical Examiners, 11 Cal.3d 1, 17; 112 Cal.Rptr. 786, 520 P.2d 10 [1974]..... 10

Durant v. City of Beverly Hills, 39 Cal.App.2d 133, 139; 102 P.2d 759 [1940]..... 9

Elliott v. City of Pacific Grove, 54 Cal.App.3d 53, 57; 126 Cal.Rptr. 371 [1975]..... 9

Fullerton Joint Union High School Dist. v. State Bd. of Education, 32 Cal.3d 779; 187 Cal.Rptr. 398, 654 P.2d 168 [1982]..... 23

Horn v. County of Ventura, 24 Cal.3d 605, 612; 156 Cal.Rptr. 718, 596 P.2d 1134 [1979]..... 31

In Re Antazo, 3 Cal.3d 100; 89 Cal.Rptr. 255, 473 P.2d 999 [1970]..... 23

Kennedy v. City of Ukiah, 69 Cal.App.3d 545; 138 Cal.Rptr. 207 [1977]..... 22

McKinny v. Board of Trustees, 31 Cal.3d 79, 98-99; 181 Cal.Rptr. 549, 642 P.2d 460 [1982]..... 31

Swanson v. Marin Mun. Water Dist., 56 Cal.App.3d 512, 523; 128 Cal.Rptr. 485 [1976]..... 9,22

Toward Utility Rate Normalization v. Public Utilities Com., 22 Cal.3d 529, 543-44; 149 Cal.Rptr. 692, 585 P.2d 491 [1978]..... 9,22

D. Statutes

California Public Utilities
Code, §1757..... 18

No. 87-51

In The

SUPREME COURT OF THE UNITED STATES

October Term, 1987

MAGDALINE M. HANSEN, individually and on behalf of all those similarly situated,

Appellants,

v.

CITY OF SAN BUENAVENTURA,

Appellee.

On Appeal from the Supreme Court of the State of California

MOTION OF APPELLEE TO DISMISS OR AFFIRM

Pursuant to Rule 16.1, appellee, the City of San Buenaventura, respectfully requests this Honorable Court to dismiss the appeal now pending on the grounds that the judgment rests on an adequate non-federal basis, and the federal questions presented are so unsubstantial as to require no further argument; or in the alternative, to affirm the decision of the California Supreme Court.

STATEMENT OF THE CASE

This appeal seeks to attack the validity of water rate ordinances enacted by the City of San Buenaventura.[1/] Specifically, appellants assert that the ordinances are unconstitutional because higher water rates were established for customers located outside the City than for those within.

The facts pertinent to this motion are accurately and fairly described in the "Appendix to Jurisdictional Statement"[2/] at pp. 1-15 (the Opinion of the California Supreme Court) and in the "Findings of Fact and Conclusions of

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1/ The initial rate ordinance establishing a 70% differential for outside-City use was adopted in 1972. The differential was confirmed by later City Councils in 1975 and 1977. (Exh. 37-39, 56)

2/ Herein described as "App."

Law"[3] of the trial court. The Opinion of the California Supreme Court[4] and the Findings, when compared to the alleged facts set forth in the Jurisdictional Statement filed by appellants, amply demonstrate that appellants are simply wrong when they state, "The facts of this case are undisputed."[5]

After nine days of trial, extensive testimony from expert witnesses, and numerous exhibits, the trial court concluded that appellants were not denied equal protection of the laws. (App. 300, 329) Appellants' claims primarily are factually based, charging the City with a deliberate attempt to treat them unfairly, and the

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3/ Herein called "Findings" (App. 231-333).

4/ Herein called "Opinion."

5/ Jurisdictional Statement (herein described as "J.S." p. 9).

trial judge decided the facts against them. (App. 261-274) The California Supreme Court agreed with the trial court. (App. 27-40)

Appellants' "Statement of Facts," however, re-argues the evidence as though this matter were still before the trial judge. (J.S. 8-24) Furthermore, they selectively use only the evidence they consider favorable to their case. Appellants wholly fail to carry out their duty to set forth the facts in the light most favorable to the judgment below.

For example, they repeatedly assert that there is ". . . no cost difference whatsoever" in providing water to customers inside and outside the City. (J.S. i-ii, v, 19, 25, 33) Yet the trial court found precisely to the contrary. Appellants' costs of service were not the same as customers

within the City; they were greater. (App. 259-63, 279-81, 283; see also, Opinion, App. 31-32) Appellants even assume there is no difference in costs when framing the first question presented by their appeal. (J.S. i-ii) And they go still further to state that the City admits that its higher outside rates are not based on cost differences. (J.S. 20) This is simply untrue. Appellants rely upon only a portion of the City's answer to an interrogatory, but the full answer clearly shows that Ventura made no such admission. (C.T. 519, 531; App. 261, 283, Exh. Q)

Appellants' legal argument also rests on the false statement, repeated often, that Ventura's water system was financed entirely from revenues from the sale of water, and so outside-City customers contributed equally to those

within. They state this as an accepted fact. (J.S. ii, 20, 21) Yet, again, the trial court specifically found otherwise. City general funds, grants, power tax revenues, and acreage and connection fees paid only by customers within the City all went to support the water system. (App. 276, C.T. 527-28, R.T. 705, 778, 887-88) Customers outside the City paid none of these, and their financial contributions were not the same as those within the City. Contrary to appellants' repeated claims (J.S. 24, 32, 38, 52), the trial court found that those customers outside the City were not "similarly situated" to those within, and the California Supreme Court agreed. (App. 264-65; see also, Opinion, App. 27-32)

In short, appellants' initial statement of the "facts" is nothing more than a review of their assertions at

trial, on disputed issues, without acknowledging that the trial court found against them, and without discussing the City's evidence in support of the findings. Appellants were not "singled out" for unjust discrimination; their rates were not based simply on their nonresident status. (App. 260-74, 297-300, 515-16) The rate surcharge was fully justified on a number of appropriate rate-making bases, including higher costs of service, the fact that the water system was supported by inside-City contributions not made by nonresidents, and the fact that nonresidents did not bear the same financial risks as those within the City.

The Court of Appeal specifically declined to rule on appellants' equal protection arguments, relying instead on what the Court viewed as common law principles. In any event, the Appellate

Court's judgment was reversed by the California Supreme Court. (App. 3)

The Supreme Court of California granted review:

> "to resolve the important question of whether a municipal utility may recover a reasonable rate of return on its investments and to clarify what circumstances may be considered by a court in determining whether a rate is reasonable." (App. 2)

The Court determined, based upon the specific facts in this case, that the classification of customers by the City and the higher outside rates were justified and reasonable. The decision is amply supported by established California law, and presents no substantial federal question for review by this Court.

I. THE JUDGMENT RESTS ON AN ADEQUATE NON-FEDERAL BASIS. NO SUBSTANTIAL FEDERAL QUESTION IS PRESENTED

Under established California law, utility customers may be classified "upon any reasonable basis," and a rate differential may rest upon "cost of service or some other reasonable basis." (Durant v. City of Beverly Hills, 39 Cal.App.2d 133, 139 [1940]; County of Inyo v. Public Utilities Com., 26 Cal.3d 154, 159 fn. 4 [1980]) Rates established by a city are presumed to be fair and reasonable, and will be upheld if supported by any conceivable state of facts. (Elliott v. City of Pacific Grove, 54 Cal.App.3d 53, 57 [1975]; Toward Utility Rate Normalization v. Public Utilities Com., 22 Cal.3d 529, 543-44 [1978]; Swanson v. Marin Mun. Water Dist., 56 Cal.App.3d 512, 523 [1976]; see also Dandridge v. Williams, 397 U.S. 471, 485; 25 L.Ed.2d 491

[1970]; McDonald v. Bd. of Election Com. of Chicago, 394 U.S. 802; 22 L.Ed.2d 739 [1969]; McGowan v. Maryland, 366 U.S. 420; 6 L.Ed.2d 393 [1961]) Appellants bear the burden of showing that the City's classification of customers and rates were unfair or unreasonable. (D'Amico v. Board of Medical Examiners, 11 Cal.3d 1, 17 [1974]; App. 16-18; McGowan v. Maryland, supra; Federal Power Com. v. Hope Nat. Gas Co., 320 U.S. 591, 602; 88 L.Ed. 333, 345 [1944])

The fundamental question in this case is whether appellants' rates and the differential were reasonable. That is the "beginning and end of the judicial inquiry." (App. 17-18) Appellants' average monthly water charge was $14.51, and they virtually conceded

that the total charge was reasonable.[6/] Their basic complaint was that they were not charged the same as customers within the City. After reviewing all of the evidence, the California Supreme Court further determined that the surcharge too was reasonable. This appeal, under the guise of an equal protection challenge, is nothing more than an effort to overturn the California Supreme Court's determination that the evidence supported the reasonableness of the rates. The Supreme Court pointed out that without the surcharge, users inside the City "would be subsidizing out-of-city rate payers . . ." (App. 34)

6/ The findings demonstrate that "plaintiffs presented no credible evidence that the rates in question were unreasonable" (App. 3[illegible]:#68). The findings show that the City submitted a number of studies which indicate the reasonableness of the rates. (App. 319:#97; 325:#125-26)

The evidence showed that in 1923 Ventura purchased its municipal water system, financing the purchase price through a general obligation bond issue. (Exh. 51-53, D, J) Between 1925 and 1960, the City authorized four additional general obligation bond issues to enlarge, improve and modernize the water system. (Exh. E-I, GG) These bonds were a lien upon all private property within the City. Property outside of the City was not subject to risk of repayment. The same was true with respect to a $58 million contract obligation with the State of California to obtain supplemental water from the State Water Project. (Exh. MM)

Throughout the years, the City also used general fund monies and other funds to help finance, operate and improve its water system. These revenues were in addition to water rates

collected from customers. City general funds were used to pay the salaries of City employees who performed accounting, billing, purchasing, legal and other administrative services for the water system, and to provide warehouse and office space for water system employees. (R.T. 967, 1015, Exh. T-Z) Numerous grant funds were secured and utilized by the City for the benefit of the water system. (R.T. 886-890) The City also made a number of substantial transfers from its general fund to the water fund either at little or no interest. (R.T. 996-1000, Exh. FF) Substantial power tax revenues were also used within the water system, representing transfers of tax payments made by City residents only. (R.T. 1003, Exh. II) In addition, new customers within the City were required to pay connection and acreage fees in order to

obtain water service. Contrary to what appellants say (J.S. 34-35), such funds were utilized for the benefit of the entire water system, and not merely to supply specific properties. (R.T. 765-66, 933, 992-1000, Exh. EE, App. 277) Customers and developers located outside of the City did not make such payments. (R.T. 933, 994-95, 1136, App. 276)

The vast majority of the City's outside customers were added in 1966 and 1969 when the City purchased the Mound and Saticoy Water Companies. Saticoy, which was the larger of the two companies, served both within and outside the City boundaries. Both companies were substandard. Their water supplies from local wells did not meet public health standards, and the City was required to abandon the wells and purchase more costly water at wholesale

in order to supply these customers. (R.T. 690, 1066, 1068-69, 1078, App. 243-251) The California Supreme Court called attention to the fact that appellants "fail to mention that the cost allocated to nonresidents covered only the cost required to supply them." (App. 35) There was expert testimony that the City's extra costs in replacing these polluted well supplies were sufficient reason alone for the price differential. (R.T. 1080-81)

The Mound and Saticoy systems were also deficient in storage facilities. Connection to the City system gave these new customers substantial and immediate benefits: better fire protection, and needed system reliability by virtue of the capacity made available in the City's existing storage tanks, treatment plants, pumping stations and major transmission lines. (Exh. R, pp. 25-26;

R.T. 1081-83; C.T. 514-16; App. 253-57) But such benefits also used up reserve capacity inside the City, and the trial court found that such benefits "have corresponding costs to inside residents and customers." (C.T. 529, App. 279, 280) If the City had been required to build these facilities, such costs would have been taken into account in setting outside rates. The court concluded:

> "The fact that some of such facilities had already been constructed by the City, for the benefit of their own future growth, does not make them of less value to the outside customers, or of less cost to the City users." (C.T. 548; App. 314)

At the trial, there was also expert testimony based on the "utility method" of analyzing rates. The utility method is a cost of service analysis widely used throughout the nation.

(R.T. 732-34; App. 278-86)[7/] It provided for a rate of return to the City based upon those City facilities that were devoted to the use of the outside-City customers. The California Supreme Court found that using a rate of return concept would be appropriate, stating that such a rate of return was, "in essence, payment for the use of property of another." (App. 23) Using the utility method, a differential of 98.5% would have been reasonable under the facts in this case. (R.T. 831-36; Exh. S; App. 15, 312) The California Supreme Court noted that, "nonetheless, Ventura continued to impose the 70

7/ This method of utility rate-making is recommended by the American Water Works Association. Furthermore, the method had been previously utilized and approved by the predecessor to the present California Public Utilities Commission in reviewing outside-City rates. (App. 242-43, 278-79, Exhs. K and L)

percent surcharge it had established in 1972." (App. 21)

The trial court found, based upon extensive evidence, and the California Supreme Court affirmed, that customers outside of the City had not made the same contributions to the water system as those within, that they did not bear the same risks, and that increased costs of service were present. In short, appellants were not similarly situated to customers within the City, and a reasonable basis existed for classifying them separately and charging the higher rates. Whether a difference in rates is justified, or constitutes unjust discrimination, is a question of fact, not law. (City & County of San Francisco v. Western Air Lines, Inc., 204 Cal.App.2d 105, 137 [1962]; Bowers v. Bernards, 150 Cal.App.3d 870, 873 [1984]; California Public Utilities Code, §1757; Alabama

Pub. Serv. Com. v. Southern R. Co., 341 U.S. 341; 95 L.Ed. 1002 [1951]; Barringer & Co. v. United States, 319 U.S. 1; 87 L.Ed. 1171 [1943])

II. STANDARD OF REVIEW UNDER THE EQUAL PROTECTION DOCTRINE

In seeking review of their equal protection claims, appellants argue that nonresidents are a "suspect class; therefore the "strict scrutiny" test should be applied. Appellants' stated reason is that they are politically powerless, but no case supports this legal position. The California Supreme Court declined to extend the suspect class analysis, stating:

> "We have categorized only a few classifications as suspect, namely classifications involving race, alienage, or national origin." (App. 46-47)

California conforms to the most recent statement of the rule by the United States Supreme Court:

> "The general rule is that legislation is presumed to be valid and will be sustained if the classification drawn by the statute is rationally related to a legitimate state interest. . . . When social or economic legislation is at issue, the Equal Protection Clause allows the states wide latitude, . . . and the Constitution presumes that even improvident decisions will eventually be rectified by the democratic processes.
>
> The general rule gives way, however, when a statute classifies by race, alienage or national origin. These factors are so seldom relevant to the achievement of any legitimate state interest that laws grounded in such considerations are deemed to reflect prejudice and antipathy -- a view that those in the burdened class are not as worthy or deserving as others. For these reasons and because such discrimination is unlikely to be soon rectified by legislative means, these laws are subject to strict scrutiny and will be sustained only if they are suitably tailored to serve a

> compelling state interest. . . .
>
> Legislative classifications based on gender also call for a heightened standard of review. That factor generally provides no sensible ground for different treatment . . . Because illegitimacy is beyond the individual's control and bears 'no relation to the individual's ability to participate in and contribute to society, '. . . official discriminations resting on that characteristic are also subject to somewhat heightened review." (Cleburne v. Cleburne Living Center, 473 U.S. 432; 87 L.Ed.2d 313, 320-21 [1985])

The State's concern that rates be fair and efficient represents a clear and substantial governmental interest. (Central Hudson Gas v. Public Service Comm'n, 447 U.S. 557, 569; 65 L.Ed.2d 341 [1980])

Where social or economic regulations are involved, the so-called "rational basis" standard of review applies. (Minnesota v. Clover Leaf

Creamery Co., 449 U.S. 456; 66 L.Ed.2d 659 [1981]; Schad v. Mt. Ephraim, 452 U.S. 61, 68; 68 L.Ed.2d 671 [1981]; U.S. Railroad Retirement Bd. v. Fritz, 449 U.S. 166, 176; 66 L.Ed.2d 368 [1980]; New Orleans v. Dukes, 472 U.S. 297; 49 L.Ed.2d 511 [1976]; Dandridge v. Williams, 397 U.S. 471, 485; 25 L.Ed.2d 491 [1970]) Water rates are economic regulations subject to review under the rational basis test. (Toward Utility Rate Normalization v. Public Utilities Com., 22 Cal.3d 529 [1978]; Kennedy v. City of Ukiah, 69 Cal.App.3d 545 [1977]; Swanson v. Marin Mun. Water Dist., 56 Cal.App.3d 512 [1976]) Under the traditional rational basis test, there is a presumption of constitutionality, and the court requires only that the distinctions drawn in the challenged statute bear some rational relationship to a conceivable legitimate state

purpose. (Fullerton Joint Union High School Dist. v. State Bd. of Education, 32 Cal.3d 779 [1982]; Curtis v. Board of Supervisors, 7 Cal.3d 942 [1972]; In Re Antazo, 3 Cal.3d 100 [1970]; New Orleans v. Dukes, 472 U.S. 297; 49 L.Ed.2d 511 [1976])

The United States Supreme Court has ruled that nonresidency is not sufficient to invoke the strict scrutiny test. (Holt Civic Club v. Tuscaloosa, 439 U.S. 60; 58 L.Ed.2d 292; 99 S.Ct. 383 [1978]) Indeed, appellants' inability to vote in City elections does not equate to political powerlessness. As a practical matter, most utility rate decisions turn upon rate hearings, not upon councilmatic elections. At the very rate hearing in question, appellants were represented by a distinguished member of the county board of supervisors. (Exh. 40)

Political influence at the local level can be exerted, and often is, in many ways -- lobbying, petitions, testimony at hearings, political contributions, and letters to the editor, among others. Moreover, viewed from a statewide perspective, nonresident customers have equal power to seek legislation governing rate-setting by municipalities, and the potential power to elect representatives who will seek such legislation. Appellants are no more politically powerless as customers of a municipal water system than they were as Mound and Saticoy customers.

Finally, the California Supreme Court noted that the reasonableness test applied to municipal rates "is somewhat more stringent than the bare rational-basis test." (Opinion, App. 48-49) It concluded:

> "Ventura has met the reasonableness standard; a

fortiori, it passes the rational-relationship test." (Opinion, App. 49)[8/]

III. APPELLANTS WERE NOT "SINGLED OUT" FOR UNREASONABLE DISCRIMINATION

The dominant thrust of appellants' equal protection challenge is the claim that nonresident customers were singled out for unjust discrimination solely on the basis of their nonresident status. (J.S. i, 5-6, 52, 55) They rely heavily upon early correspondence between the City's Public Works Director and the City's rate consultant, Wilsey & Ham. Appellants charge that the City directed the consultant to omit revenues from certain oil company customers in order to justify a preordained 70% sur-

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8/ It is worthy of note, in addition, that the trial court specifically found that "no matter what standard of review is used it has been fully demonstrated that the customer classes and rates in question are reasonable." (App. 328)

charge. (J.S. 12-15, 42, 45-46) In essence, appellants sought to prove that the Ventura City Council in 1972 acted in bad faith, and deliberately attempted to profit from them.

Once again, appellants attempt to put this Court into a fact-finding role. And again, their evidentiary allegations are directly contrary to the trial court Findings, confirmed by the California Supreme Court. The trial court specifically rejected the contention that the City had ". . . deliberately sought to impose or enact an unjust water rate, or arbitrarily and unjustly sought to classify its various water customers . . ." (App. 260)

Appellants seek to color the issue further by saying the nonresident customers were "swept" and "pulled" into the system "involuntarily." (J.S. 24, 34 fn. 15, 36) The fact is that the

Mound customers were also shareholders in the company and had to approve the transfer to the City; and the Saticoy acquisition was approved by the California Public Utilities Commission without protest from any Saticoy customers. (App. 6, 9, 244-45, 247)

The evidence at trial showed that early in the rate study, the City's consultant recommended a surcharge of 38.8%. However, this conclusion was based on data that had not been properly segregated and identified. As the consultant learned later, the City had supplied him with revenue figures not only from the domestic customers, but also from a separate class of industrial untreated water customers. These industrial customers (oil companies) received nonpotable water for secondary recovery purposes. Such water was unfit for domestic use, and was not supplied

through the domestic water system. These untreated water customers had been treated as a separate class with separate rates since 1923. Upon learning of this mistake, the consultant revised his study so as to consider only those revenues and expenses related to the domestic water supply system. The result was a 70% surcharge recommendation. (App. 14-15, 39-40, 289-93; R.T. 519-28, 532-53) Appellants tried throughout the trial to imply that this change was made merely to profit from the outside-City domestic water customers. But the consultant was a witness at the trial, was cross-examined, and the court found against appellants.

Perhaps, however, the most succinct answer concerning the exclusion of oil company revenues came from appellants' own expert witness at the

trial. He agreed that the untreated water customers comprised a separate class, and that their revenues and expenses should not be included in studies to determine domestic water rates. (R.T. 366-67; App. 288)

The City Council's action to increase the existing 32% surcharge to 70% did not occur until 16 months after the consultant's report. (Exh. 39, Exh. 35, C.T. 517; App. 257-58) This was also three years after the Saticoy acquisition and six years after the Mound agreement. Certainly the timing would not indicate that the City was bent upon trying to profit from its outside customers.

At the time the rate ordinance was adopted, the City had already replaced the polluted Mound and Saticoy water supplies, and had undertaken a major water construction program, in part to

supply the outside-City customers. (R.T. 690, 992-99) At the rate hearing, the City manager stated that it was not the City's intention to "make money on a vital public service," but rather the surcharge was a "method of directly eliminating subsidy of outside water users." (J.S. 16, 17) No revenues from the City's water system went into the City's general fund. All revenues were put back into the water system. (R.T. 161, 340, 345; App. 294)

A. The Validity Of The Ventura Rate Ordinances Are Not To Be Determined On The Basis Of Appellants' Claimed "Actual And Articulated Purposes"

Appellants' equal protection challenge also rests upon the legal premise that the City is bound by the "actual and articulated purpose" for which the surcharge was imposed. (J.S. vii, 42) Appellants allege that the

true purpose of the 1972 rate ordinance was to recover "fictitious subsidies," and that the validity of the ordinance cannot be supported by "after-conceived justifications." (J.S. 46-47)

Their argument assumes, to begin with, that some kind of legislative record is available on which motivation can and should be judged. This is not true. Rate-making is a legislative act. (San Diego Land & Town Co. v. National City, 174 U.S. 739; 43 L.Ed. 1154 [1899]; American Microsystems, Inc. v. City of Santa Clara, 137 Cal.App.3d 1037 [1982]) Legislative action does not require hearings or an evidentiary record. (Bi-Metallic Invest. Co. v. State Bd. of Equalization, 239 U.S. 441, 445; 60 L.Ed. 372, 375 [1915]; McKinny v. Board of Trustees, 31 Cal.3d 79, 98-99 [1982]; Horn v. County of Ventura, 24 Cal.3d 605, 612 [1979])

When reviewing a legislative act, the law is clear that it is the result that counts, not the motivation of the legislative body, nor what the legislative body may have considered. (Federal Power Com. v. Hope Nat. Gas Co., 320 U.S. 591, 602; 88 L.Ed. 333, 345 [1944]) Appellants argue that in 1972 the City Council had before it and relied only upon the original Wilsey & Ham report, that the report was part of a deliberate scheme to overcharge nonresidents, and that the report contained certain admittedly improper factors in justifying the surcharge.[9] In essence, appellants assert that it was improper for the trial court to receive expert testimony and other

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[9] The trial court explicitly stated, "I don't know whether the City Council, 17 or 18 months after the Wilsey-Ham report, relied on each of those things or not. I don't know what they thought." (R.T. 373)

evidence, beyond the Wilsey & Ham report, that justified the reasonableness of the ordinance. This is not the law. The court's review of a city council's legislative act is not confined to what the members may have considered, but will be determined on the basis of all the evidence at the trial, including "expert testimony presented by the parties." (County of Inyo v. Public Utilities Com., 26 Cal.3d 154, 159-60 [1980]; Wisconsin v. Federal Power Comm., 373 U.S. 294, 309; 10 L.Ed.2d 357, 368 [1963]; Spring Valley Water Works v. San Francisco, 124 F. 574, 584-85 [C.C.N.D. Cal. 1903])

Appellants also ignore the fact that this case involves three separate council actions in 1972, 1975 and 1977, with different council memberships acting on each, and that a subsequent rate study by Brown & Caldwell,

following nationally recognized principles, indicated that the 1972 rates actually charged to outside-City customers were insufficient by $80,200 to cover their share of costs, and that a differential of 98.5% would have been justified. (App. 312; see also Opinion, App. 15, 21) Furthermore, the evidence showed that the improper factors considered in the Wilsey & Ham report affected the surcharge by only 2.9%, and that all of the data still supported the 70% recommendation. (R.T. 552-53; App. 96-97)

In the last analysis, the overriding fact is that all the claims of deliberate discrimination were judged by both the trial court and the California Supreme Court to be without merit.[10/]

10/ At the trial, appellants attempted to show the basis for the outside rate by offering testimony from a person in the audience (a member of the County Board of Supervi-
(Continued) .

IV. THE CITY OF VENTURA IS ENTITLED TO A RATE OF RETURN ON THE FACILITIES DEVOTED TO THE USE OF OUTSIDE-CITY CUSTOMERS

Appellants argue finally that it is a denial of equal protection for the City to charge a profit, or a return on investment, from its nonresident customers without making the same charge against its resident customers, "since both classes are similarly situated in every context relevant to the Water System." (J.S. 51-52) Of course, the premise of this argument, namely, that

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sors) when the 1972 ordinance was adopted. This testimony was first allowed over the objection of the City, but eventually was stricken. Nonetheless, appellants at the trial continued to attack the motives of the 1972 City Council. So much so, the City finally brought five members of that City Council into court, prepared to testify. At that point, appellants objected to such rebuttal testimony, and the issue was withdrawn from the case. All testimony of the Council's original intent and reliance was stricken from the record. (R.T. 950-65)

both classes are similarly situated, has been specifically rejected in the Findings. (App. 264-65) That could be a complete reply. However, rate of return was a major issue during the trial and before the Court of Appeal, and perhaps warrants additional discussion.

Indeed, it was the rate of return issue that principally caused the California Supreme Court to hear the case. The Court of Appeal had determined that allowing any rate of return was the equivalent of "profit," and was unlawful. This was a startling conclusion, unsupported by prior law, and with far-reaching policy implications. The policy importance of the question was aptly underscored by the appearance of Amici Curiae in the California Supreme Court on behalf of 19

cities, including San Francisco, Los Angeles, Fresno and Sacramento.

Much of the Supreme Court's Opinion is devoted therefore to a comprehensive historical review of municipal rate-making authority. The Court concludes that municipalities clearly have the authority to earn a return on their investment in utility plant. This is true even though such return may be considered "profit." It should be understood, however, that this case was tried on a more limited basis. The rate of return concept was not employed as a way to make a profit for the City. Ventura did not make transfers from its water system into the City general fund. Rather, rate of return merely comprised part of a "cost of service" analysis used by the City experts (App. 278-86, 312-13), and was but one of several bases used to

demonstrate the reasonableness of the rate ordinances.

A composite rate of return of 8.67% was utilized in determining the appropriate surcharge for outside-City customers. The California Supreme Court stated that this rate of return "was much lower than that granted a number of companies regulated by the California P.U.C." (App. 21) The composite rate consisted of three components: (1) an amount necessary to provide for adequate depreciation; (2) an amount required to pay interest on debt; and (3) a charge for the use of facilities serving the outside customers, based upon the City's paid-up equity in those facilities. This rate of return was viewed by the experts and the trial court as an "economic cost," and not as a profit. (R.T. 300, 763, 919-20, Exh. R, p. 25, C.T. 530; App. 282) Customers inside

the City were charged a 2.8% rate of return, which included only depreciation and debt requirements. (Exh. R, p. 7) The difference between the two rates of return reflects the fact that City residents were not charged for the use of their own property.

Appellants argue that as rate-payers they provided the investment, and therefore the City should not be allowed to collect a return on capital they contributed. (J.S. 50) They say the City is "extracting a profit only from nonresidents," and this demonstrates the clearest case of discrimination resting solely on nonresident status. (J.S. 52) But, again, appellants are factually wrong. The vast majority of the outside-City customers were added in 1969, and had not helped to pay for the Ventura water system. The trial court

specifically found that the former Mound and Saticoy customers were supplied from

> "sources and facilities for which they have not paid a proportionate share of the total expenses, both prior to adoption of the ordinance in question and since." (C.T. 515; App. 254)

The rate of return utilized in the utility method of analysis simply required that outside customers pay for the use of existing City facilities devoted to their use. Those facilities were no longer available to the City to serve its own inhabitants, and had not been paid for by appellants.

As a policy matter, the California Supreme Court pointed out that cities would no longer provide service outside their boundaries if they could not charge for the use of their facilities. This would discourage cities from improving service to outlying areas, as occurred here. If the Mound and Saticoy

companies themselves had improved their water supply and system facilities as Ventura did for them, these costs would certainly have been reflected in appellants' rates. To refuse to allow Ventura to recover those same costs would result in a subsidy to the outside-City customers. Municipal rates to nonresident customers must always be reasonable, and the paucity of cases in California indicates that cities have not taken unfair advantage of nonresident customers.

V. CONCLUSION

For the foregoing reasons, the appeal docketed by the appellants should be dismissed for lack of a substantial federal question and because the judgment rests on an adequate non-federal basis, or in the alternative,

this Court should affirm the decision of the California Supreme Court.

DATED: August 31, 1987

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